Lund University

School of Economics and Management
Department of Business Law

Treaty Override in German Domestic Law – In line with the Constitution?

by

Kathrin de Kock

HARN60 Master Thesis

Master's Program in European and International Tax Law

2014/2015

Spring semester 2015

Supervisor: Cécile Brokelind

Examiner: Oskar Henkow

28.05.2015

Author's contact information:

K.dekock@web.de

00491798456849

Contents

Summary

The case BFH I R 4/13 decided by the German Federal Fiscal Court is serving as a starting point for this thesis. The case is still pending at the highest German Constitutional Court and therefore it is not finally decided yet. In its decision the court arrived at the conclusion, that a provision in the German Income Tax Act is a treaty override and further that this treaty override is not in line with the constitution.

In order to understand why the Federal Fiscal Court is of the opinion that the provision is not in line with the constitution one has to examine the German case in detail. A discussion is going on in German legal doctrine which is taken on by the court as well. Therefore this thesis aims at shedding some light on the discussion and to give an outlook on possible decisions that could be decided upon by the constitutional court.

Furthermore treaty overrides are not a domestic problem alone. Therefore it is inevitable to look at the effects and consequences a decision would have on other states.

Finally the relationship to EU Law and possible procedures at the European Court of Justice will be an issue in this thesis as well.

Abbreviation list

BFH	German Federal Fiscal Court
BStBl.	Bundessteuerblatt
BVerfG	Highest German Constitutional Court
DTC	Double Tax Convention
EStG	German Income Tax Act
EU	European Union
FA	German Tax Authorities
GmbH	German limited partnership
DTC	Double Tax Convention
OECD-MC	OECD Model Convention
PE	Permanent Establishment
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union

1.Introduction

1.1. Background

Nowadays a lot of states regulate the jurisdiction of taxing rights in cross border situations through tax treaties with other states. Most of the tax treaties used are drafted in accordance with a model convention. One of the most common model conventions used is the one provided by the OECD (Organization of Economic Co-operation and Development) and aimed at allocating taxing rights to the states.[1]

One could think that, because of the use of tax treaties, problems arising through cross border transactions are solved completely. However even though states conclude tax treaties with other states some still have provisions in their domestic law that provide for a different solution than provided by the tax treaty. These provisions override the tax treaty concluded by the contracting states.

It is clear that such a practice causes several problems since the tax treaty provision at issue is simply overridden by a domestic law provision of one of the states. This might leave the ones covered by the treaty with a possibility of double taxation even though a treaty existed that should have avoided this problem.[2]

The German Federal Fiscal Court (BFH) dealt with a case that concerned a treaty override which was found in a section of the German Income Tax Act (EStG). However this time the court in its judgement examined the question of the constitutionality of the section concerned. As this court is not able to declare a provision unconstitutional it referred the case to the highest German constitutional court in order for it to decide on that matter.

The decision started a renewal of the ongoing discussion if a treaty override and especially the section at issue is in line with the German constitution or not. Therefore this thesis aims at shedding some light on the reasons for the decision of the BFH and further to try and give an answer on the question of constitutionality of the section at issue in the case.

A treaty override is something that does not only concern domestic law. Therefore another aspect of this work is the question of what effects a possible declaration of unconstitutionality of the German provision at issue will have on other states.

---

[1] M. Lang, 'The Procedural Conditions for the Implementation of Tax Treaty Obligations Under Domestic Law' (2007) Volume 35 Issue 35, Intertax, p. 146(146) and OECD Model Tax Convention 2014.

[2] S.Sachdeva, ‚Tax Treaty Overrides: A Comparative Study of the Monist and the Dualist Approaches' (2013) Volume 41 Issue 4 Intertax, p. 180(181).

1.2. Method and material

In order to give an answer to the above mentioned questions a legal dogmatic approach has been taken.[3]

The case at issue in this paper is only available in German. Therefore it was tried to summarize the case as best as possible in English to give the reader a detailed idea about all aspects of the case. The German Income Tax Act is not available as an official translation therefore some translations by other authors were used to make the provision and its content more understandable. In order to get an idea of the discussion concerning the question examined in this paper it is necessary to use German articles as well. Therefore the articles and other documents used here are partly in German and partly in English.

To elaborate further on the issue several journal articles regarding that topic are taken into account. In addition to that formal documents like those issued by the German government, the OECD and the tax treaty between Germany and Italy are used. Finally case law of the European Court of Justice and German courts are used as well.

1.3. Delimitation

The problem of treaty overriding is linked to not only national law but has a connection with several different types of legal systems.[4] Therefore the work presented here concerns mainly domestic law and international law. The domestic law here is brought forward and examined in the light of the case which will be one of the main parts of work. Since the main topic is that of a treaty override double tax treaties and especially the one concluded between Italy and Germany will be at issue here. For the main question which is examined in this thesis German constitutional law plays the most important role. Therefore the subject of EU Law and a possible infringement of fundamental freedoms by the consequences resulting out of the application of the provision that contains a treaty override will only be examined briefly.

1.4. Outline

This paper has been divided into 6 chapters. A starting point is the introduction to give a general overview of the topic as such. In the second chapter the German case will be discussed in detail. A description of the

[3] S. Douma: *Legal Research in International and EU Tax Law (Kluwer, Deventer, 2014).*
[4] For an overview of the different links and relationships of the legal system concerned: C. de Pietro, ‚Tax Treaty Override and the Need for Coordination between Legal Systems: Safeguarding the Effectiveness of International Law‘(2015) Volume 7 No.1 World Tax Journal.

taxation of German partnerships will be included in this chapter as well. It is crucial to understand the special way partnerships are taxed in Germany to understand some of the aspects of the case. Further a description of Section 50 d (10) EStG, the provision at issue here, will be given as well. The next chapter includes a detailed analysis of the different opinions existing on the constitutionality of treaty overrides. Before that a definition of treaty override is given. The final chapter before the conclusion includes a discussion of the effects a treaty override has on other countries and the effect the decision of the BVerfG could have on other states. Finally the last chapter of this thesis is the overall conclusion.

2. German Case BFH I R 4/13

The German Federal Fiscal Court has, with its decision on the 11th of December 2013, raised the question if a national provision, which contains a treaty override, is in line with the German constitution. The court dealt in its decision with a case that was already dealt with by one of Germanys Fiscal Courts and which was then appealed in front of the BFH. On the following pages the case is going to be explained in detail.

2.1. Facts of the case

On the one hand there was a German partnership a GmbH & Co. KG (GmbH). Its partners were firstly another German partnership (A-GmbH) and secondly B. Additionally a silent partnership existed between relatives of B and the GmbH. One of the relatives, hereinafter called C, entered into a loan arrangement with the GmbH. This loan agreement resulted in payment of interest from the GmbH to C. As C was a resident of Italy the interest was accordingly subject to income tax in Italy. However the German tax authority (FA), which was the defendant in the present case, made the interest subject to income tax in Germany as well. The FA concluded that the interest income of C is to be treated as business income of a German PE and was therefore underlying limited tax liability in Germany.[5]

However a double tax convention (DTC) between Germany and Italy, concluded in 1989, existed.[6] Article 11(1) and (2) of this DTC, which are in accordance with Art. 11 of the OECD Model Convention (OECD-MC) read as follows:

‘1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

[5] Section 15(1) sentence 1 number 2 in connection with Section 49(1) number 2 a EStG in the version of 1997.
[6] DTC between Germany and Italy from 1989 found in Bundesgesetzblatt, Jahrgang 1990, Teil 2. English version of Germany-Italy treaty can be found in IBFD database.

2.However, interest arising in a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.'[7]

In the present case C was a resident of Italy, the other Contracting State, who was paid interest that arose in Germany, the Contracting State. According to paragraph one Italy was allowed to tax the interest since it got the taxing jurisdiction.

However paragraph two provided Germany with the option to tax the interest as well as long as this did not exceed the amount described in the paragraph. If Germany taxed the interest as well Italy would deduct the amount paid by C according to Art. 24 (2a) sentence 2 of the DTC.[8] Therefore Germany was, based on the DTC, only entitled to deduct capital gains tax as a withholding tax according to domestic law with the limitation of the 10% mentioned above and deducted at source.[9]

In spite of that the FA used the domestic provisions that would apply to this situation in a domestic context and would give Germany the right to gain higher tax revenue from C. This would be like that, because the limitation given by Art. 11 (2) OECD-MC was disregarded.

In order to understand the FA approach it is necessary to examine the German way of taxing partnerships. The principle used by Germany is called the Co-entrepreneur principle.

2.1.1. Taxation of partnerships in Germany (co-entrepreneur principle)

According to German law partnership are taxed based on the transparency principle. This means that it is not the partnership as such that is subject to individual income tax. The construct of the partnership is only used to determine the profit that was generated. That is the first step of taxation. Afterwards the profits are split up among the partners of the partnership. This split up is based on the amount of shares the shareholders hold in the partnerships. As the second stage of taxation the profits are taxed in the

[7] Art. 11 OECD Model Tax Convention 2014 (OECD-MC).
[8] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (12).
[9] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (13) and Art. 49 (1) number 5 a in connection with Art. 20 (1) number 1 EStG.

hand of the partner. So it can be said that it is not the partnership as such that is subject to income tax but its partners.[10]

The only time the partnerships acts as a taxable person is when trade tax is involved.[11] There the partnership is the taxable person and liable to trade tax according to German law.[12]

However, even though partnerships are not a subject for income tax they still have partial legal capacity in Germany[13] resulting in the possibility to enter into civil law contracts with their partners. The transactions the partners and the partnership enter into are recognized for tax purposes.

Therefore German tax law in Section 15 (1) sentence 1 no.1 EStG includes the interest that is paid by a partnership to its partner for a loan granted by the partner as income derived from a business activity.

This means that the interest income is classified as business income according to Section 15 (1) sentence 1 number 2 EStG, which would mean that the income in the present case is subject to limited tax liability. The income is only subject to limited tax liability because C does not have his domicile or his habitual abode in Germany but derives income originated in Germany.[14] If the income is classified in this way in a domestic context it is classified as business income according to Art. 7 (1) and (2) of the DTC in a cross border context as well.

The court concluded that the FA was right in its classification of the income when it comes to a setting without a DTC or a purely domestic one. However the convention between Germany and Italy provided in Art.7 (7) the rule that Art. 11 is lex speciales and should apply even though there are domestic provisions that tell otherwise. Those domestic provisions would not apply in these cases. [15]

However to keep the taxing right in such cases Germany has in its domestic law a provision that deals with exactly that. According to Section 50d (10) EStG, income in the sense of Section 15 (1) sentence 1 number 2 EStG is to be qualified as business income. Section 50d (10) EStG was used by the FA in the present case to keep the taxing right in the hands of Germany.[16]

The Court disagreed with the way the FA treated the interest income. It was made clear that Italy as the resident state got the taxing right according to

---

[10] Hennrichs in Tipke/Lang: *Steuerrecht (21st edn O.Schmidt, Köln, 2013)*, §10 Besteuerung von Mitunternehmerschaften, para.10.
[11] Hennrichs in Tipke/Lang: *Steuerrecht (21st edn, O.Schmidt,, Köln, 2013)*, §10 Besteuerung von Mitunternehmerschaften, para.21.
[12] Section 5 (1) sentence 3 German Trade Tax Act (GewStG).
[13] Hennrichs in Tipke/Lang: *Steuerrecht (21st edn, O.Schmidt,, Köln, 2013)*, §10 Besteuerung von Mitunternehmerschaften, para.12.
[14] Section 49 (1) number 2a EStG and Section 1 (4) EStG.
[15] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (14).
[16] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (2).

Art.11 (1). Germany as the state paying the interest was only given a limited taxing right as explained above. In this case Italy would deduct the taxes paid in Germany from the taxable base in Italy according to Art. 24 (2a) sentence 2.[17]

The Court established the above mentioned and went on to explain the reasons for the decision:

First the explanation concerned the special domestic law provisions that classified the income as (Gewerbebetrieb). The Court reasoned that Art. 11 of the German Italian tax treaty is to be giving priority. This is to be the case especially when it comes to domestic law.[18]

The Court referred in its ruling to the so called 'OCED partnership report' from 1999. The report states that the income is basically business income. However the Court goes on and says that even though the income is qualified as business income there is still the possibility that the resident state qualifies the income to be a special income type.

This is especially interesting in the so called outbound case. The case at present is such an outbound case where the person who is receiving the interest is a resident in Italy but the money is paid by Germany. As can be seen from the above mentioned German tax authorities qualify the income as business income. So when Italy classifies it as interest income there is a conflict. The OECD solved this problem with Art. 3(2) of the OECD-MC which is included in the German Italian tax treaty as well. There it is made clear that the resident states domestic law is to be followed. Nevertheless the report mentioned above is in no way binding on the court. The BFH follows the static interpretation which means that only the circumstances and the ideas of the two contracting parties at the time of conclusion of the treaty play a role for the interpretation of the German Italian tax treaty of 1989.[19]

The court goes on further and refers to several of its earlier rulings saying that the principles established in these rulings are to be used in the present case as well.[20]

One of its more decisions is one from 2007. There a German partnership got a loan from one of its partners. It paid interest to the partner. The partner was a resident of the United States of America. German authorities claimed the income to be business income and accordingly taxed it referring to Section 15 (1) sentence 1 no.2 EStG. However a tax treaty existed between Germany and the US which was concluded in the year 1989.[21] Section 50 d (10) EStG was not in force yet since it was not included in German

[17] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (12/13).
[18] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para (14).
[19] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (15).
[20] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (16).
[21] BFH I R 5/06 – 17.10.2007 in BStBl II 2009, 356.

domestic law until 2009.[22] The court in this case came to the conclusion that the taxing right was with the resident state, which was the US in this case, and that Germany did not have the right to tax the interest.[23]

The court continues his examination of the case and deals with Art.11 (5) of the German Italian tax treaty which resembles Art.11(5) of the OECD Model. There it is stated that:

> 'Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.'[24]

Paragraph five is an exception to the general rule in Art.11 (1) and (2) which, as explained above, provide the taxing right to the state of residence of the receiver of the interest and at the same time provide a limited taxing right to the Source State. Paragraph five is applicable if the person that is paying the interest has a permanent establishment in one of the contracting States. It does not matter if the person that pays the interest is a resident of one of the contracting States or not. However it is important that the given loan has 'an obvious economic link with a permanent establishment owned in the other contracting State by the payer of the interest.'[25] If this is the case then the interest is arising in the state in which the PE is located. However the exception to Art.11 (1) does only apply if the link between the loan and the PE is obvious.[26]

The court in the present case argued that C had a PE in Germany. This was the case, because he was one of the partners of the GmbH and therefore the permanent establishments of the GmbH are to be qualified as his permanent establishments. However the loan and the permanent establishment have no economic link and therefore the loan is not to be seen as belonging to the permanent establishment. The reason for that is that for the loan to be seen as belonging to a permanent establishment it has to be shown that the loan is listed as an asset in the balance sheet of the permanent establishment.[27] It is to be assumed that this was not the case which is why the court rejected the application of paragraph 5.

---

[22] BT Drucksache 16/10189, Entwurf eines Jahressteuergesetzes 2009 (2009), 02.09.2008.
[23] BFH I R 5/06– 17.10.2007 in BStBl II 2009, 356, para. (35).
[24] Art.11 (5) OECD-MC.
[25] OECD Commentary Art. 11, para. 26.
[26] OECD Commentary Art. 11, para. 27.
[27] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (18).

The next part of the courts argumentation is of more interest. There the court deals with Section 50d (10) EStG. In the next paragraph Section 50d should be explained in more detail.

2.1.2. Section 50 d (10) EStG in detail

Section 50d (10) EStG was incorporated into German law in 2009. It constitutes a reaction to the decisions made by the BFH which differ from the view of the tax authorities as explained above. The provision applies to cases where the tax has not been assessed finally.[28] The section expresses the view of the tax authorities and goes directly against the view and opinion of the BFH up to this point. The tax authorities made the legislator include this section into the German Income Tax Act.

Section 50d (10) sent. 1 EStG as it reads in its old version:

'If remuneration within the meaning of section 15 para. 1 sent. 1 no. 2 sent. 2, second half-sentence and no. 3, second half-sentence, is governed by a treaty for the avoidance of double taxation and if the treaty does not contain any explicit regulation with respect to such remuneration, then such remuneration is deemed to be exclusively business profit for purposes of application of the treaty.'[29]

However after a BFH decision from 2010 an additional sentence was added to the provision which was numbered as sentence 3. Sentence 1 of Section 50d(10) EStG was left untouched. The new sentence 3 reads as follows:

'Irrespective of the provisions regarding the attribution of assets to a permanent establishment under a treaty for the avoidance of double taxation, the remuneration of a shareholder is to be attributed to the same permanent establishment to which the investment in the performance underlying the remuneration is to be attributed […].'[30]

The provision in this form made clear that the remuneration that a shareholder gets has to be attributed to the same PE as the performance of the said remuneration. It can be seen as 'a fictitious attribution of revenue to a PE'[31]

To justify the section the tax authorities based the content of Section 50d (10) EStG on the OECD Partnership Report which was published in 1999

[28] C.Schmidt, ‚Sondervergütung auf Abkommensebene – Was nun, Finanzverwaltung und Gesetzgeber? Zugleich Anmerkung zum BFH Urteil vom 8.9.2010, I R 74/09', (2010) DStR, p.2436(2437).
[29] A.Cloer and T.Hagemann, 'Federal Tax Court Holds Treaty Override Unconstitutional', (2014) European Taxation, p. 510(512), unofficial translation by the authors.
[30] Ibid.
[31] C. Kahlenberg, ‚German Treaty Override Violates Constitutional Law', (2014) Bulletin for International Taxation, p. 480(481).

and uses this principle as well.[32] However the OECD Partnership Report has no legal power since it is only a statement made by several states of the OECD. Therefore it is not used as an aid to interpret tax treaties by the domestic courts. The courts rather use the information which show the intention of the two contracting parties when they were concluding the double tax treaty.[33]

The German legislator does not see a treaty override in Section 50d (10) EStG. [34] In contrast to that the BFH, in the case discussed in this paper and in other cases as well, and several authors of German legal doctrine believe that there is a treaty override.[35]

Section 50d (10) EStG is only applicable in cross-border situations where a double tax treaty exists. It deals with special partner remuneration. The special partner remuneration is included in the German Income Tax Act in Section 15. However it is only applicable if there is no specific definition of special partner remuneration in the double tax treaty.

One further problem arises when Section 50d (10) EStG is at issue. The Co-entrepreneur principle is used in Germany and Austria but is not known in other countries. In some of its tax treaties Germany has included this principle but in most of the treaties it is not part of the treaty. The reason for that is mainly, that other countries do not use and know the Co-entrepreneur principle and are therefore not willing to incorporate the principle in their tax treaties with Germany.[36]

2.1.3. Continuation of the case

Resulting out of the application of Section 50d (10) EStG is that the interest income is to be classified as business income according to Art.7 OECD-MC which resembles Art. 7 of the German-Italian tax treaty. However the court mentioned one problem that appears when Art.7 is applied. The German-Italian tax treaty includes seven paragraphs for Art.7. However the OECD model tax convention is subject to continuous changes over time. Nowadays Art.7 only has four paragraphs. Nonetheless Art.7 paragraph 7 which was problematic in the courts view nowadays resembles Art.7 paragraph 4 since it was renumbered as paragraph 4.[37] Paragraph four reads as follows:

---

[32] OECD: 'The Application of the OECD Model Tax Convention to Partnerships', (1999) Issues in International Taxation No. 6.
[33]Gosch in: Kirchhof: *EStG*, (12.edn, Schmidt, Köln, 2013), §50d para.44.
[34] Bericht des Finanzausschusses zum JStG 2009, BT-Drs. 16/11108, p. 29.
[35] For example: Gosch in: Kirchhof: *EStG*, (12.edn, Schmidt, Köln, 2013), §50d para.44a; Loschelder in: Schmidt: *EStG* (33.edn, C.H. Beck, München, 2014), §50d para. 60; G. Frotscher, , Treaty Override und § ESTG § 50d Abs. ESTG § 50D Absatz 10 EStG' (2009) IStR, p.593(597).
[36] A.Cloer and T.Hagemann: ‚Federal Tax Court Hold Treaty Override Unconstitutional'(2014), Volume 54 No. 11 European Taxation, p.510 (511).
[37] Art.7 Model tax convention 2010, History paragraph 4.

‘Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provision of those Articles shall not be affected by the provisions of this Article.’[38]

This basically means that other Articles that are more specific shall apply before Art. 7 applies. This would lead to a circular argument: First Art.11 dealing with interest income should be applied according to the tax treaty. However, because of the German provision Art.7 is to be applied. If then Art.7 (7) (now Art.7 (4)) is applied one would end up at Art.11 again, because that one is the more specific Article in this case.

This makes sense but would leave the application of Section 50d (10) EStG completely pointless. However the court found a solution for this. It argued that the circular argument as it was described above cannot be applied. To make sense of Section 50d (10) EStG it is rather to be assumed that the legislator planned to apply Art.7 (1) only and leaving out the rest of the provision. This would circumvent the circular argument and Section 50 d (10) could be applied.[39]

The overall result of this argumentation is that the interest paid to C in Italy is, according to German law, to be qualified as business profit which is taxable in Germany.

Nevertheless one question still remains. Even if the law and especially Section 50d (10) EStG is applied in this way it is still not proven that this Section of the Income Tax Act is indeed in line with the German constitution. This was a second issue that was raised by the court in this procedure and it was dealt with in the judgement as well. This part of the judgement should be explained in more detail in the following section.

2.1.4. Section 50d (10) EStG in line with Constitution?

The court addresses two issues. First the court is of the opinion that Section 50d (10) EStG is not in line with international law which results in an infringement of Cs subjective constitutional rights. The second issue is the retroactive impact of the provision, which goes against the principle established in Art.20 (3) GG.

Compared to other German domestic law, the German constitution is the law with the highest rank which makes it superior to tax treaties as well. The German courts when interpreting tax treaties use a way which is as close to the Constitution as possible. However the Constitution should be interpreted in line with international law.[40]

---

[38] Art.7 (4) OECD-MC.
[39] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (22).
[40] S.Sachdeva, ‚Tax Treaty Overrides: A Comparative Study of the Monist and the Dualist Approaches’ (2013) Volume 41 Issue 4 Intertax, p. 180(187).

2.1.4.1. Section 50d (10) EStG and international law

First the court deals with Section 50d (10) EStG. It notes that this provision of the Income Tax Act does deviate from Art.11 of the German-Italian tax treaty in so far as it distributes the taxing rights differently. The tax treaty is a treaty that was agreed upon by Germany and Italy and is based on international law. Therefore Section 50d (10) EStG constitutes a violation of the principle 'pacta sunt servanda'[41] ('agreements must be kept'[42]).

This principle implies that the contracting parties, in this case Italy and Germany, '[...] respect and apply the treaty provisions'.[43] Furthermore the principle is established in the 'Vienna Conventions on the law of treaties' which was agreed upon in 1969.[44] The convention entered into force in January 1980 and both Italy and Germany belonged to the parties that agreed upon the convention. The convention as such is applicable to all treaties that were concluded after 1980. Other treaties that were concluded before underlie the principles of customary international law. However the principles established in the Vienna Convention are based upon customary international law.[45] The tax treaty between Germany and Italy, which is subject to the present case, was concluded in 1989 and therefore the Vienna Convention is applicable to it.

The preamble of the Vienna Convention makes clear that the principle of 'pacta sunt servanda' is especially recognized by the parties. This principle is one of the fundamental principles of international law.[46] Furthermore the Articles 26 and 27 are important to establish what is meant by the principle:

Article 26 says that:

'Every treaty in force is binding upon the parties to it and must be performed by them in good faith.'[47]

This article was implemented to make sure, that parties follow the rules and provision that are part of the treaties they entered into. The term 'binding upon the parties' shall mean that the State as a whole is bound to the treaty. Furthermore 'performed by them in good faith' shall mean that the provisions of the treaty are to be implemented into the domestic law of the state by the parties. However it still does depend on each individual State how exactly they are implemented since the specific and unique legal

---

[41] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (30).
[42] W.Kessler and R.Eicke, 'German Treaty Overrides: Contractual Duties Meet Fiscal Interests' (2010) Tax Notes International, p.41 (41).
[43] OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989), p.R(8)-5.*
[44] Vienna Convention on the Law of Treaties (1969).
[45] OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989), p. R(8)-5.*
[46] Ibid. (9), p. R(8)-6.
[47] Vienna Convention on the Law of Treaties (1969), Art.26.

systems of the States have to be kept in mind. The way how the provisions are implemented is not important it is only the result that comes out of it which is of importance in connection with the Convention.[48]

Whereas Article 27 provides:

'A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46.'[49]

Article 27 can be seen as an addition to Article 26. It makes clear that a party to the treaty is not allowed to use its domestic law to justify its failure in following and using the provisions and rules of a treaty concluded by this party.[50]

In the present case Germany clearly uses its domestic law to gain the taxing right by invoking Section 50(d) (10) of its Income Tax Act.

Nevertheless the court argues that the 'pacta sunt servanda' principle does not give the provisions, which are established in treaties, the rank of international law and therefore they do not have precedence over domestic law.[51]

The rank of provisions that are included in a double tax convention instead is dealt with in the German Constitution. There, Art. 59 (2) GG makes clear that for example double tax conventions need an approval of law to gain the rank of a federal law. They do not have precedence over other domestic provisions even when they gain the rank of federal law.[52]

When it comes to tax treaties Germany uses the dualist way. That means that the treaties as such have no legal effect without further intervention by the legislative. They gain the legal status as soon as they are implemented into domestic law. The tax treaties gain the rank of an ordinary statue.[53]

And therefore they do not gain the rank of constitutional law through the 'pacta sunt servanda' principle. Which further results in the assumption that a treaty override is in line with the constitution, because treaty provisions are indeed breached but they do not have the rank of constitutional law. This is the view of the common opinion in German legal doctrine.

This opinion is explained by the court in the following paragraphs. The court discusses the term treaty override. It establishes that according to earlier decisions and the common opinion in legal doctrine a treaty override

---

[48] OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989), (10) p. R(8)-6.*
[49] Vienna Convention on the Law of Treaties (1969), Art.27.
[50] OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989), p. R(8)-6.*
[51] BVerfG 2 BvR 225/69 – 09.06.1971, in BVerfGE 31, 145.
[52] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (30).
[53] S.Sachdeva, ,Tax Treaty Overrides: A Comparative Study of the Monist and the Dualist Approaches' (2013) Volume 41 Issue 4 Intertax,, p.180(180/198).

is an unilateral act which constitutes out of the fact that one party breaches the treaty. The common opinion said that it is not ideal to have a treaty override but it is, at least in German domestic law, not a case of a breach of the Constitution.[54]

Nevertheless the court goes on and states that it is not going to follow the common opinion mentioned above. It will rather agree with the opinion expressed in a previous case from 2012 which dealt with Section 50d (8) EStG and is still pending at the BVerfG as well. Therefore the court is of the opinion that Section 50d (10) EStG indeed is not in line with the German constitution.[55]

The court further explains the opinion and the reasons for this opinion.

The court uses other decisions to back up its argumentation. One of the cases that are used is a decision called 'Görgülü' which was decided in October 2004.[56] The case dealt with a father who tried to gain the custody for his illegitimate son who was put up for adoption by his mother without the fathers' knowledge. The case lasted for several years, went through several courts and the father finally took the case to the European Court of Human Rights. When the case was to be decided in front of the BVerfG again, the court made a comment on the role of conventions like the European Convention on Human Rights (ECHR). It stated that the ECHR has to be taken into account by the state.[57]

This is to be taken from the rule of law ('Rechtsstaatsprinzip'). The ECHR, like a double tax treaty, needs an approval of law to become a law of federal rank therefore the court uses this principle for the case at issue here. The German legislator should, because of the constitution, consider international law. This is derived from the principle of 'Vökerrechtsfreundlichkeit' which can be found in Art. 25 GG. The German term could be translated to 'friendliness towards international […] law'.[58]
The court in the present case referred to the results of the 'Gorgülü' decision and transferred the principle for the present case.
Only when there is a sufficient justification are exceptions from this principle acceptable too.[59]

In addition to that the court mentions the fact that a discussion is going on in German literature concerning the constitutionality of treaty overrides. Klaus

---

[54] BFH I R 120/93 – 13.07.1994 in BStBl II 1995, 129, para.9; J.Bron, ‚Das Treaty Override im deutschen Steuerrecht vor dem Hintergrund aktueller Entwicklungen' (2007) IStR, p.431(436).
[55] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (32).
[56] BVerfG 2 BvR 1481/04 – 14.10.2004 in BVerfGE 111, 307.
[57] BVerfG 2 BvR 1481/04 – 14.10.2004 in BVerfGE 111, 307, paras. (31-35).
[58] For example: W. Kessler and R. Eicke, 'German Treaty Overrides: Contractual Duties Meet Fiscal Interests' (2010) Volume 60 Number Tax Notes International, p.41(42).
[59] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (34).

Vogel started this discussion. He argues that a treaty override is definitely not in accordance with the German constitution. He derives this from the rule of law ('Rechtsstaatsprinzip') in Art.20 GG. Furthermore Vogel mentions the 'Gorgülü' decision which was explained above and uses it in the same way as the court does. In addition to that he remarks that in a lot of states, where the parliament has to agree to the conclusion of a treaty, the treaty override is not in accordance with the constitution since it breaches international law.[60]

However there are other opinions in German literature that argue that a treaty override is indeed in line with the constitution. Since this is a summary of the court's decision these opinions will be explained and examined in a later paragraph.

As has been mentioned above the German legislator is of the opinion, that Section 50d (10) EStG does not include a tax treaty override at all.

The legislator argues that the use of the Co-entrepreneur principle is one of the most important principles of German tax law. It is used to ensure that Co-Entrepreneurs and sole traders are taxed with the same result. Section 50d (10) EStG has been implemented to make sure that the principle is used in cross-border situations as well. It should lead to an equal treatment of German and foreign partners.[61]

The court dismisses this argumentation and declares that the legislator disregards the double tax treaty that was concluded by Germany and Italy. The double tax treaty should be interpreted according to international law and therefore the principles of domestic law are not to be used first but are subsidiary to the international law. The court further does not see an acceptable justification for the breach of international law.[62]

The legislator is not in a position to interpret the law. This task is done by the courts in Germany and the courts are of the opinion that Section 50d (10) EStG constitutes a treaty override. [63]

Furthermore the court dismisses the argumentation that the legislator brought forward concerning the equal treatment of German and foreign partners. It is made clear that German and foreign partners are by no means in a comparable situation. The German partners and foreign partners have different territorial sources of income. The argument that sole traders and co-partners should be taxed in the same way cannot be upheld either. The

---

[60] K.Vogel and M.Lehner: *DBA* (5th edn, C.H. Beck, München, 2008), Grundlagen para.204/205.
[61] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (37).
[62] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (38/39).
[63] C.Schmidt, ‚Sondervergütung auf Abkommensebene – Was nun, Finanzverwaltung und Gesetzgeber? Zugleich Anmerkung zum BFH Urteil vom 8.9.2010, I R 74/09', (2010) DStR,, p.2436(2438).

problem there arises as soon as a double tax treaty is involved. Double tax treaties do not include sole traders in their content.

Furthermore the co-entrepreneur principle is used by Germany in several double tax treaties with other states. The court therefore argues that it cannot be said that there is a need to make sure that the principle is used by implementing Section 50d EStG. Therefore Section 50d (10) cannot be justified by the argument that foreign and German partners should be treated in the same way. Neither can it be justified by saying that the co-entrepreneur principle is unknown in other countries and that their unwillingness to use this principle provides the need to have a Section like Section 50d (10) EStG.[64]

The breach of international law cannot not be accepted even though the legislator made sure that the tax that is paid in the other contracting state can be credited against the German tax which is payable. The breach of international law is still there. That is not mended by the reduction of the payable tax through the credit method.[65]

The court mentioned in the case Gorgülü that a breach of international law is alright and justified if it constitutes the only chance to prevent a violation of the German constitution.[66] However these special circumstances are not given in the present case. This leads to the opinion of the court that Section 50d (10) EStG constitutes a breach of international law.

Resulting out of that is that it constitutes a violation of the German constitution, since the breach of international law is at the same time a breach of the rule of law in Art.20 (3) GG and Art.25 GG.[67]

2.1.4.2. Retroactive Implementation

The 'real' retroactive implementation occurs if a provision is concluded that violates another provision which was already in existence. The violation could consist out of a tax increase or the creation of a tax burden. The 'real' retroactive implementation does only arise if the provision should be used for assessment periods that are already concluded.[68]

One of the principles of German tax law is that the citizens have to be able to trust the legislation and to trust in the provisions that are in force.[69] The citizens' trust is disappointed if the legislator decides a provision that puts worse consequences into place than the one that the citizens were trusting in. The procedure is not always deemed to be out of line. It can be justified.

---

[64] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (40-42).
[65] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (43).
[66] BVerfG 2 BvR 1481/04 – 14.10.2004 in BVerfGE 111, 307, para. 35.
[67] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (48).
[68] BVerfG 2 BvR 882/97 – 03.12.1997 in BVerfGE 97, 67.
[69] BFH I R 1/04 – 14.03.2006 in BStBl II 2006, 549, para. (24).

This is the case if the trust of the citizens was not justified, if the new provision should have been expected to be released in that way, if the provisions at that point were not clear or if there were reasons of common welfare that justified the 'real' implementation.[70]

Therefore the court in the present case argues that the retroactive implementation of the provision is not in line with the constitution either. The 'real' retroaction is not possible according to the BVerfG. The reason for that is that the provision would concern all open cases where the tax has not been assessed finally but where the tax claim already accrued.

The citizens' trust has to be protected against retroactive access by the legislator. But this is only the case if the provision at issue, here Section 50d (10) EStG, was suitable to make the citizens trust in the provision for a period of time. If the legislator later goes back and changes the provision that would mean that the trust of the citizens is not protected anymore. This is a violation of the rule of law ('Rechtsstaatsgrundsatz') in Art. 20 (3) GG.[71]

The question was therefore if the provision was suitable to be trusted to exist for a period of time?

When the new provision was included in the German Income Tax Act an additional document was issued which included the reasons and background for the implemented provisions. This document was issued by the German federal parliament. As a reason for the implementation of the provisions at issue here (Section 50d (10) EStG and Section 52 (59a) EStG) it gave the fact that the provisions would represent the way of taxation as it was used at this point.

However the court argues that the fiction of qualifying interest income like the one in the present case, as business income according to Art.7 OECD-MC which is included in Section 50d (10) EStG does not resemble the way of taxation at this point. The case law of the BFH at this point and today follows a different path where this kind of income is qualified as interest according to Art.11 OECD-MC. Therefore the legal situation was clear and the case law of the BFH was suitable to be trusted. This results in a 'real' retroactive implementation of the provision. [72]

The court itself makes in its ruling a reference to an article written by Geritt Frotscher.[73] This article concerns a decision by the Finance Court in Munich

---

[70] BVerfG 2 BvL 6/59 – 19.12.1961 in BVerfGE 13, 261 and BFH I B 92/08 23.09.2008 in BStBl II 2009, 524.

[71] C.Schmidt, ‚Sondervergütung auf Abkommensebene – Was nun, Finanzverwaltung und Gesetzgeber? Zugleich Anmerkung zum BFH Urteil vom 8.9.2010, I R 74/09', (2010) DStR, p.2436(2439) and BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (51/52).

[72] BT Druck 16/11108 and BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (53/54).

[73] G. Frotscher, '§50d Abs. 10 EStG ist völkerrechtskonform und rückwirkend anzuwenden', (2009) IStR, p.864.

which was later appealed at the BFH.[74] The constitutionality of Section 50d (10) EStG was at issue in this case as was the retroactive implementation.

The case at issue dealt with royalty payments that were paid by a German partnership to an American partner. Again Section 50d (10) EStG was used by the tax authorities and this practice was confronted by the plaintiff. Again the court was of the opinion that the retroactive implementation existed in this case and that this was not permissible.[75]

However Frotscher comes to a different conclusion. He is of the opinion that there is not a retroactive implementation which is against the German constitution. He uses the argument that the approach at this point was not clear since BFH and tax authorities used a different way to tax such royalties. Furthermore he argues that the BFH did not comment on the so called inbound cases until its decision from 17.10.2007[76] which was not published until 2009. The years at issue in this case were the years 2001 until 2003. This results in the fact that the citizens' trust in the provision was not eligible to be protected.[77]

Nevertheless the court did not follow Frotschers opinion in its ruling.

As a final result concerning the whole case the court makes clear that it is of the opinion that Section 50d (10) EStG is not in line with the German constitution, because of the above mentioned reasons. Furthermore the court establishes that there is a 'real' retroactive implementation which is not in line with the constitution either since it breaches the rule of law ('Rechtsstaatsprinzip') in Art.20 (3) GG. Therefore the court refers the question if the provision is in line with the constitution to the BVerfG. The BVerfG alone has the power to decide about the constitutionality of the provision at issue. However the case is at the moment still pending at the highest court.[78]

3. Analysis of the BFH decision

As mentioned above a discussion is going on in German literature concerning the constitutionality of a treaty override.

---

[74] FG München 1 K 1816/09 - 30. 7. 2009 in EFG 2009, 1954, appealed at the BFH I R 74/09.
[75] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264.
[76] BFH I R 5/06 - 17.10.2007,in BStBl II 2009, 356.
[77] G. Frotscher, '§50d Abs. 10 EStG ist völkerrechtskonform und rückwirkend anzuwenden', (2009) IStR, p.864(866).
[78] The pending case can be found at: http://www.bundesfinanzhof.de/anhaengige-verfahren/revisionsverfahren (accessed 21.04.2015), the reference numer is: 2 BvL 15/14.

However to get a better overview of what exactly is meant by the term treaty override it is important to define the term and explain it a little bit further.

3.1. What is a tax treaty override?

The OECD defines the term treaty override in its report from 1989 as follows:

'a situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State.'[79]

This means that a treaty override exists if the legislator made a provision which is intended to contradict the provisions that are enacted in tax treaties.

In general it can be said that a treaty override exists if the act that constitutes a treaty override is accepted by the legislative. In addition to that a tax treaty can be identified when the legislation makes clear that a treaty provision is not to be applied in a case. It does not matter if it the legislation brings forward an explanation and a justification. A treaty override does exist even if it is justified.[80]

Still it is often argued that a treaty override is used to avoid fraud or abuse. This is explained by the fact that the legislator wants to make sure that no benefits are granted that were not included in the treaty to begin with since they were not thought of when the treaty was concluded.[81]
Reasoning for a treaty override which is often used as well is the avoidance of double non-taxation. However tax treaties are designed to counter this double non-taxation as well. This would mean that a treaty override, which is clearly going against a treaty, is not justified by this argumentation.[82]

Furthermore the OECD mentions three other situations that could be mistaken for treaty overrides but which are none. However these situations could have a treaty override involved and they mostly lead to the same consequences and effects.

First there is the situation when a State makes a change of law because there is a court decision that goes against the provision interpretation of a tax

---

[79] OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989),* p. R(8)-3.
[80] L. Schoueri, ‚Tax Treaty Override: A Jurisdictional Approach'(2014) Volume 42 Intertax, p.682(684).
[81] For example: W. Kessler and R. Eicke: 'German Treaty Overrides: Contractual Duties Meet Fiscal Interests' (2010) Volume 60 No. 1 Tax Notes International, p.41(42).
[82] L. Schoueri, ‚Tax Treaty Override: A Jurisdictional Approach'(2014) Volume 42 Intertax,, p.682(685).

treaty. In this circumstances a treaty override does not exists if the legislative and administrative organs are both of the opinion that the court decision breaches the interpretation agreed upon. Here a treaty override is part of the process but it is the court's decision that is considered to be one.

Second a State is allowed to change the domestic definition of a term which is included in a tax treaty as well. However this is only allowed if the term is not explicitly defined for the usage in the tax treaty. This does not result in a treaty override if the tax treaty between the States does include a provision similar to Art. 3(2) OECD-MC. This provision makes clear that terms, which are not defined in the treaty, shall have the interpretation which is used in domestic law.
Last a State might introduce some legislation which is not in line with the tax treaty and the organs that release the new legislation are not aware of this breach or do not intend to breach the treaty. [83]

A tax treaty is a treaty between two or more States. With the conclusion of tax treaties States try to regulate the tax jurisdiction between them. Furthermore tax treaties are important instruments in State relationships. They are important for citizens of both States since they regulate the taxing jurisdiction when it comes to citizens of one State working in the other. Such treaties are needed since the domestic tax systems are hardly comparable nowadays.[84]

However when concluding a tax treaty the contracting States underlie a certain obligation to follow the treaty and not to breach it.[85] Nevertheless if for example domestic law changes a treaty override makes it easier for states to get the desired effect. This is the case, because states are saving themselves the trouble they would have to go through if they want to adjust the tax treaty. [86]

A question that should be asked if one is dealing with a treaty override is what the other party could do against it. It should not be the desired effect that one State can breach a treaty in such a way and does not have to face consequences. That is the reason why there are ways for the other state to react to a treaty override by its treaty partner.

---

[83] OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989),* p.R(8)-4.
[84] OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989)*, p.R(8)-3.
[85] OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989),* p.R(8)-5.
[86] K.Vogel and M.Lehner: *DBA* (5th edn, C.H. Beck, München, 2008), Grundlagen para. 194 and OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989),* p.R(8)-5.

According to the OECD report the other state should make sure to first file an official protest addressed to the government of the state that made the treaty override. This should happen as soon as possible and the protest should include the request to follow the treaty and not to breach it. However if that does not work out Article 60 (1) of the Vienna Convention does include options for the other state to use.[87]

'A material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part.'[88]

Nonetheless this provision can only be invoked by the other state if the breach of the treaty was a 'material' one. This is the case when a state rejects the treaty and when this is not sanctioned by the Vienna Convention. Additionally a 'material' breach exists if a provision of the treaty is violated which is 'essential to the accomplishment of the object or purpose of the treaty.'[89] If there is a material breach has to be decided depending on each individual case. Furthermore the other state has to follow the procedures that are described in Art.65 to Art. 68 of the Vienna Convention otherwise a termination of a treaty is not possible.[90]

In addition to that states have the possibility to amend the treaty which is done by mutual agreement. This procedure is based on the OECD Model Convention and therefore can be found in Art. 25 (3) OECD-MC.

It can be said that the opinion of states on treaty overrides does differ. On the one hand there are the states that are monist. In their case international law has direct effect without the need to be implemented in domestic law. Furthermore international law does prevail over national law and therefore a treaty override is considered to be not allowed in monist countries. On the other hand are the dualist states. There international law has to be implemented in domestic law giving it an equal rank to the other domestic provisions. Following that dualist states consider a treaty override as permissible.[91]

---

[87] : E.Reimer and A.Rust*: Klaus Vogel on Double Taxation Conventions* (4th edn, Wolters Kluwer, 2015, Volume 1), para.158.
[88] Art. 60(1) Vienna Convention on the law of treaties (1969).
[89] Art. 60 (3) Vienna Convention on the law of treaties (1969).
[90] OECD, 'Tax Treaty Override' *(adopted by the OECD Council on 2 October 1989),* p. R(8)-10, para. 23.
[91] C. de Pietro, ‚Tax Treaty Override and the Need for Coordination between Legal Systems: Safeguarding the Effectiveness of International Law'(2015) Volume 7 No.1 World Tax Journal and for the treatment by other countries: E.Reimer and A.Rust*: Klaus Vogel on Double Taxation Conventions* (4th edn, Wolters Kluwer, 2015, Volume 1), para.159.

3.2. Constitutionality of a treaty override – a debate in German legal doctrine

3.2.1. Art.20 (3) and Art.25 GG

The opinion that a treaty override is in line with the constitution is for example represented by Lehner. He argues explicitly against the opinion of Klaus Vogel, which was used by the court. One reason for that is that Vogel and Lehner have published a book together. In an earlier edition Vogel presented his opinion. Nevertheless in the latest edition the opinion is attacked by Lehner who took over the publication of the book after Vogels death. However Lehner expressed his opinion in other publications as well.[92]

Lehner argues that a treaty override is in line with the constitution but that it breaches the principle of 'pacta sunt servanda'. Furthermore Lehner is of the opinion that Section 50 d (10) EStG in particular includes a treaty override. This is because the Section goes against Art.3 (2) and Art.7 (7) OECD-MC. Art.3 (2) OECD-MC includes references that concern the interpretation of the provisions and the fact that terms that are not clearly defined should be interpreted according to domestic law of the state whereas Art.7 (7) deals with the precedence of specific provision like Art.11.[93]

He is of the same opinion as the court and explains that a treaty override goes against the principle of 'pacta sunt servanda' which is a principle of international law. However even though Art.25 of the German Constitution declares that principles like that are supposed to be included in German domestic law they do not gain the rank of constitutional law.[94] However the obligations that can be derived from the 'pacta sunt servanda' principle gain a certain constitutional importance in combination with Art.25 GG, the -

This is explained by the fact that the legislator has an obligation to follow and to stick to international treaties as such and that a breach of a treaty should be avoided by all means. Such a breach would include a treaty override. Nevertheless Lehner makes clear that he does not see a breach of constitutional law when it comes to that since the principle'pacta sunt servanda' and its obligation do not have the rank of a constitutional law.[95]

---

[92] K.Vogel and M.Lehner: *DBA* (5th edn, C.H. Beck, München, 2008) M.Lehner, ‚Treaty Override im Anwendungsbereich des §50d EStG' (2012) IStR.
[93] M.Lehner, ‚Treaty Override im Anwendungsbereich des §50d EStG' (2012) IStR, p.389(397).
[94] M.Lehner, ‚Treaty Override im Anwendungsbereich des §50d EStG' (2012) IStR, p.389(398).
[95] M.Lehner, ‚Treaty Override im Anwendungsbereich des §50d EStG' (2012) IStR, p.389(400/401).

As explained above Vogel and the BFH are of the opinion that a treaty override is not in line with the constitution, because of the rule of law (Rechtsstaatsprinzip') in Art. 20(3) GG. Another author supporting the court and Vogel is Dietmar Gosch, who is one of the judges at the BFH. In an article which was published in 2008 he express the opinion that treaty overrides are not in line with the German constitution using the same arguments as Vogel and the BFH which he mainly derives from the BVerfG decision 'Gorgülü'. In his conclusion he urges the use of a concrete judicial review (Art. 100 GG) to shed light on the question of constitutionality of treaty override.[96] This concrete judicial review was used by the court in the present case to give the BVerfG the chance to comment and decide on the question of constitutionality of treaty overrides.[97]

However Lehner does not agree with the explanation that this can be taken from the Gorgülü decision in general. He argues that the result of that approach would be that provisions that are part of an international treaty are gaining a higher rank than principles of international law since the principles are having the rank of a simple federal law. Therefore his result is that the legislator does have the obligation to follow and not to breach international treaties but that, when it comes to a violation of the treaty, this does not go against the German constitution.[98]

Another author of German legal doctrine is Andreas Musil. He is of the same opinion than Lehner and supports the opinion that a treaty override is in line with the constitution even though it is a breach of international law. He gives another argument for this opinion in one of his articles. There he states that there is a valid reason that Art. 59 (2) GG says that international treaties only gain the rank of simple federal law. Otherwise the German legislator would lose control over the drafting of such treaties if all of them are gaining constitutional importance.[99]

All in all it can be said that the BFH follows the way of saying that treaty overrides are not in line with the constitution. This is based on the argument that a treaty override as such goes against the rule of law ('Rechtsstaatlichkeitsprinzip'). This is derived from the 'Gorgülü' decision where the BVerfG made clear that international treaties should be regarded. In addition to that Art. 25 which includes the 'friendliness towards

[96] D. Gosch, ‚Über das Treaty Overriding - Bestandsaufnahme – Verfassungsrecht – Europarecht' (2008) IStR , p.413.
[97] BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264, para. (57).
[98] M.Lehner, ‚Treaty Override im Anwendungsbereich des §50d EStG' (2012) IStR, p.389(401/402).
[99] A. Musil, ‚Treaty Override als Dauerproblem des Internationalen Steuerrechts' (2014) IStR, p.192(194); likewise: R.Ismer and S.Baur, ‚Verfassungsmäßigkeit von Treaty Overrides' (2014) IStR, p.421.

international law' is breached as well. This view is supported by several authors of German legal doctrine as can be seen above.

On the other hand other authors are of the opinion that a treaty override is not desirable but in line with the constitution since they do not see a breach of it. They argue that the principles of international law and treaty provisions do not gain constitutional rank and therefore do not breach the constitution. As can be seen from the discussion a part of it is the disagreement concerning the ranks certain provisions gain.

However both sides agree that a treaty override breaches international law and especially the principle of 'pacta sunt servanda'.
Therefore it will be interesting to see how the BVerfG will decide on this matter and which opinion it will be following.

3.2.2. Violation of subjective basic rights?

Nevertheless there is a second way the BVerfG could prove that Section 50 d (10) EStG is not in line with the constitution. This way is the examination if the subjective basic rights of the partner in the case used for this thesis are breached by Section 50 d (10) EStG.

Whenever it comes to a violation of subjective basic rights and an examination of this breach the BVerfG uses the same structure. First it establishes if there is an interference with one or more of the basic laws. This is done by looking at the scopes the basic laws protect and to establish whether the, in this case, legal positions fall within this protected scope. Finally the court inspects if there are any justifications for the interference and if this is not the case declares the breach unconstitutional.[100]

In an article published in 2009 Gerrit Frotscher uses this procedure to establish if a breach of subjective basic rights exists if Section 50 d (10) EStG is involved.[101]

He first established that Section 50 d (10) EStG does interfere with two basic laws: Art 14 GG which deals with property and Art. 3 which concerns the principle of equality before the law.[102] The reason for that is, that as soon as Section 50 d (10) EStG is used double taxation arises, because Germany as the source state taxes the income in addition to the resident

[100] S. Kielmansegg Graf, ‚Die Grundrechtsprüfung' (2008) Jus, p.23.
[101] G.Frotscher , Treaty Override und § ESTG § 50d Abs. ESTG § 50D Absatz 10 EStG' (2009) IStR, p.593.
[102] Articles of the GG and their English translation can be found at: http://www.gesetze-im-internet.de/englisch_gg/englisch_gg.html#p0079 (accessed 13.05.2015).

state. However the partner does have a right, resulting out of the double tax treaty, to avoid double taxation.

In the present case C has a legal position concerning the interest he is paid by the GmbH. Legal position like this are always included in the scope Art. 14 protects.[103] Therefore the German provision does interfere with Art. 14 GG. Furthermore there is an interference with Art. 3 GG as well. Double taxation is eliminated through the double tax treaty Germany entered into with the state, in this case Italy, if income is concerned that can be related to Italy. However with Section 50 d (10) EStG Germany establishes the double taxation again. Since the German provision aims at a specific income group, this kind of income is treated differently than other income in connection with Italy and therefore tax payers that earn these kinds of income are treated differently.[104]

Frotscher continues and examines if there is a justification for the interferences.
One problem that arises if Section 50 d (10) EStG is applied is that the tax result differs from the one agreed upon in the double tax treaty. The provision therefore replaces the treaty. As described above this results in a violation of international law, because of the breach of the treaty. Section 50 d (10) EStG is applicable as soon as the double tax treaty does not include a provision with the same effect than the German provision. This is the case if Germany was not able to include a provision like that in the treaty through the negotiation progress with the other state. Therefore this is a unilateral breach of the treaty by Germany.

Frotscher derives from this conclusion that a state which breaches international law breaches the rule of law ('Rechtsstaatsprinzip') as well since it does not follow its obligations that arise out of the treaty. He comes to the same conclusion as Vogel and the court and says that the German provision does breach the rule of law ('Rechtsstaatsprinzip') and the principle of observation of principles of international law. Therefore there is a fundamental problem with the justification of the interference in this case which basically means that this interference cannot be justified, because of the breach of international and constitutional law that is included in Section 50 d (10) EStG.

As an overall result it can be said that there is an interference in the subjective basic rights of Art. 14 GG and Art. 3 GG. This interference

[103] BVerfG 2 BvR 2194/99 - 18. 1. 2006, para. 35, in DStR 2006, 555.
[104] G.Frotscher , Treaty Override und § ESTG § 50d Abs. ESTG § 50D Absatz 10 EStG' (2009) IStR, p.593(598-600).

cannot be justified. Therefore the provision is not in line with the constitution.[105]

4. Effects on other countries

An interesting question remains: What are the effects a treaty override has on the other treaty partner. Furthermore what are the expected effects if the highest German court declares the treaty override in Section 50 d (10) EStG to not be in line with the German constitution?

For the first part the answer is quite clear. As can be seen in the German-Italian case used as an example in this paper one state has no control over the other states domestic law. So basically that means that one of the states can come up with any domestic provision that overrides the treaties it concluded with other states. The question here is: Does not this make double tax treaties between states useless? If every state could just enact any law to override the treaty?

One has to consider the use and role of tax treaties. For states it makes it easier to agree upon who gets the taxing jurisdiction. If they conclude their tax treaties in similar styles it is easier for the states to handle all the cross-border cases that come up in today's economic world in the same way where they do not have to develop a special treatment for each and every state they deal with. Most states that are part of the OECD construct their tax treaties in accordance to the OECD model[106] which makes it even easier to have a common way of taxing cross-border situations.
However since each states domestic law is different it is still a field of unsolved and arising problems.

In addition to that tax treaties are a great source for individuals to avoid double taxation and to make it easier for them to work and live in other countries than the ones they are nationals of. They can regard double tax treaties as a basis and kind of as a guarantee, agreed upon by the states, on how they will be taxed by the concerning states.

A treaty override however is threatening these functions of a double tax treaty. Just be looking at the situation from an overall point of view, several problems come to mind.

---

[105] G.Frotscher, , Treaty Override und § ESTG § 50d Abs. ESTG § 50D Absatz 10 EStG' (2009) IStR, p.593(600-601).
[106] C. de Pietro, ‚Tax Treaty Override and the Need for Coordination between Legal Systems: Safeguarding the Effectiveness of International Law', (2015) Volume 07 No. 1 World Tax Journal.

First there are the individuals whose income is subject to the tax treaties. Usually the right to tax income, which arises in another state than the one they are resident in, is given to one of the states according to the tax treaty. This is to guarantee the taxation of this income in at least one state and to avoid double taxation too.
However if the income is really taxed in the state is up to the domestic law. But just to make the description of the threats a tax treaty override holds simpler it is to be assumed that it is taxed in this state. Just like it is the case in the German-Italian case dealt with above.

Now one of the states has the taxing jurisdiction and makes use of it by taxing the income. Usually the income than is not part of the tax base in the other country which is taken care of by the exemption or credit method mentioned in Articles 23 A and B OECD-MC. However it can be the case that the other state has the right to tax the income to a certain amount as it is the case with Art. 11 OECD-MC and the German-Italian tax treaty.

If now one of the states, in case of the case which is used above Germany, has a provision in its domestic law that overrides the treaty, double taxation arises. Once the income is taxed in Italy and once it is taxed in Germany.

It is clear that if a treaty override is used basically all provisions agreed upon in a treaty can be overridden by implementing provision like that in domestic law. It is also clear that probably no state will go as far as implementing treaty overrides to go against all provisions in a treaty, because that would render the treaty basically useless. However even a few treaty overrides can be considered a problem.

As explained treaty overrides are not in line with international law but as explained above as well all a state can do about that is to try to figure out the problem with the other state and if that does not work to terminate the treaty with the other state. But with terminating the treaty it cannot use the other provision which worked without an issue either. So terminating the treaty is not the best option most of the time moreover terminating a tax treaty with another state can have consequences on other areas of international relations as well.

So far it has been established that a treaty override has effects on the other state and that it is a breach of international law as well. The other problem that needs to be examined in this context is the effect a decision of the highest German court would have concerning the constitutionality of the treaty override in the case mentioned above.

If the court comes to the conclusion that the treaty override indeed is in line with the constitution it will be accepted by the BFH and it is to be expected that an end will be put to the discussion going on for now.

The decision of the German constitutional court will not only have a certain effect on Germany and its domestic law. Furthermore other states, where a treaty override is possible, could be affected as well. The courts in those states could take the German decision as an example and use it as a reference in their own decisions regarding treaty overrides.[107]

The question is: would the use of the practice of treaty overriding by the states increase because of that? It might but a final answer cannot be given to that here.

If the court decides differently and declares the German provision not to be in line with the constitution another effect can occur. Germany will have to amend its law since the provision as such will be unconstitutional. But it has to reconsider the other treaty override provisions that are included in its domestic law as well. Other states will have to face the same issues. Their courts might follow the decision of the BVerfG if the constitutionality of treaty overrides is still an issue in their legal system.

All in all the German decision, if it declares treaty overrides unconstitutional, might put an end to the discussions and uncertainty of treaty overrides.
However it is the German court that decides this issue and the question remains if not other courts will decide differently whatsoever.

5.Treaty Override and EU Law

It is not only the relationship between international law and domestic law that should be taken into account when one is dealing with a treaty override. EU law can play an important role in the case of a treaty override as well. This is not only true for EU member states but for other states that enter into double tax treaty with the EU member states as well.[108]

As a member state of the European Union states give up part of their sovereignty for certain matters that are than dealt with according to EU law

[107] A. Musil, ‚Treaty Override als Dauerproblem des Internationalen Steuerrechts‘ (2014) IStR, p.192 (192).
[108] C. de Pietro, ‚Tax Treaty Override and the Need for Coordination between Legal Systems: Safeguarding the Effectiveness of International Law‘, (2015) Volume 07 No. 1 World Tax Journal.

instead.[109] However when it comes to direct taxation the member states have the competence on their side. This was made clear in several court decisions. Still member states have to take care and only use the competence in accordance with EU Law so in accordance with the EU treaties.[110]

Nevertheless EU tax law provisions still direct the domestic tax laws of each Member State in a way that helps to realise the internal market and to make sure that the market functions. But this is only the case:

'[…] if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States […]'.[111]

The overall goal of EU tax provisions is not to harmonize the domestic tax laws of all Member States.[112]

EU law and international law differ in so far as the EU treaties became a part of the legal systems of its Member states whereas international law needs to be implemented for dualist countries to be used or has direct effect for monist countries. Article 350 TEU states that agreements that were concluded before 1958 or before the date of the accession of Member States that entered the EU after 1958 shall not be affected by the EU Treaty provisions. However treaties that were conclude after that date are affected by EU Law since it takes prevalence over international law every time it is amended.[113]

So when Member States conclude a tax treaty with other Member States or Third States they do so in the position of a subject of international law. However since they are part of the European Union they have to take EU Law into account as well.

The European Court of Justice in its ruling concerning the case Columbus Container (C-298/05) made clear that it has no jurisdiction to decide on possible infringements of provision agreed upon in a double tax treaty by one of the concluding states. Further it made clear that the examination of

---

[109] Art. 3-6 TFEU.
[110] Case C-324/00 Lankhorst-Hohorst, ECLI:EU:C:2002:749, 12.12.2002, para.(26) or Case C-196/04 Cadbury Schweppes, ECLI:EU:C:2006:544, 12.12.2006.
[111] Art.5 (3) TEU, principle of subsidiarity.
[112] M.Helminen: *EU Tax Law – Direct Taxation 2013* (2013 Edition, IBFD, 2013), 1.2.1. Sovereignty and subsidiarity.
[113] C. de Pietro ,Tax Treaty Override and the Need for Coordination between Legal Systems: Safeguarding the Effectiveness of International Law' (2015) Volume 07 No.1 World Tax Journal p.10/12.

the relationship of a national provision and a provision of such an agreement does not fall within the scope of Community law.[114]

Therefore a treaty override does not breach the EU treaties and especially not the principle in Art.4 (3) TEU which states that Member States are supposed to make sure that the obligations arising out of treaties are fulfilled and followed. It can be said that therefore a breach of a double tax treaty by one of the contracting states, a treaty override, as such will not be affected by EU law.
However the consequences that result out of the treaty override might trigger consequences in EU law as well. This basically means that a treaty override and the tax consequences resulting out of it could infringe one of the EU basic freedoms. This happens if the situation in cross-border situations is less attractive than a domestic situation and if this is not justified by a valid reason.[115]

Therefore another possible reaction for Italy or any other Member State would be to bring the matter to the attention of the European Court of Justice. There it can be decided if a national provision such as Section 50 d (10) EStG infringes the fundamental freedoms. This could be done by an infringement procedure where a Member State brings the matter before the Commission, which than further decides on the matter. If the problem is not solved in a certain procedure the Commission will bring the case before the European Court of Justice.[116] Furthermore it is possible that national courts of EU Member States ask the European Court of Justice for a preliminary ruling concerning the accordance of a national provision with EU Law.[117]

6. Conclusion

This thesis was aiming at answering two questions. First if a treaty override is in line with the German constitution and second what kind of effects could be expected to occur to other states because of the decision by the BVerfG.

For answering the first question it became clear that there are basically two opinions concerning this question. Both do agree that there is a breach of

[114] Case C-298/05, Columbus Container Services B.V.B.A & Co. v Finanzamt Bielefeld-Innenstadt, ECLI:EU:C:2007:754, 06.12.2007.
[115] A. Musil, ‚Treaty Override als Dauerproblem des Internationalen Steuerrechts‘ (2014) IStR, p.192 (196).
[116] Art. 258/259 TFEU.
[117] Art. 267 TFEU and V. Englmair, ‘The Relevance of the Fundamental Freedoms for Direct Taxation’, in M.Lang/P.Pistone/J.Schuch/C.Staringer: *Introduction to European Tax Law on Direct Taxation* (3rd Edition, Linde, Wien, 2012), p.46.

international law. However they disagree when it comes down to the constitutionality of treaty overrides. Both sides do have strong arguments on their site. Nonetheless it is hard to give an outlook on how the BVerfG will decide on this matter. In a way it is to be expected that it will follow the argumentation brought forward by the BFH. Nevertheless declaring a provision not to be in line with the constitution is not something done lightly by the BVerfG.

It is clear that a treaty override is something that should be avoided in international tax practice and still it is something that happens all the time. Somehow a stop should be put to the use of treaty overrides to not render tax treaties useless but if it is the right way to do this through the constitution is not easy to answer. However the argumentation by the court and Vogel does make sense. States are bound to regard international law after all and that is something they should do. Furthermore the other way shown by Frotscher which concerned an infringement of the German basic rights can be followed. However it should be kept in mind that this is only a short and not complete examination.

The second question is easier to answer. The effects the decision could have on other states have been described above. They could either follow or disagree with the decision of the BVerfG. This decision might be a starting point for a uniform solution to the treaty override problem.

The upcoming decision is capable of raising awareness to the treaty override included in German domestic law. This might end up in an examination of the problem on EU level as described above. This will give other states and their individuals the chance to at least react to the consequences that follow out of the treaty override, even if the court's decision declares the provision to be in line with the constitution. However if such procedures will succeed at the European Court of Justice is another question not being dealt with in this thesis.

After all it can be said that the decision is something that will have an effect on other states and on the discussion on treaty overrides regardless of how the court will decide.

Bibliography

Books

E.Reimer and A.Rust*: Klaus Vogel on Double Taxation Conventions* (4th edn, Wolters Kluwer, 2015, Volume 1)

Gosch in: Kirchhof: *EStG*, (12.edn, Schmidt, Köln, 2013)

Hennrichs in Tipke/Lang: *Steuerrecht* (21st edn O.Schmidt, Köln, 2013)

K.Vogel and M.Lehner: *DBA* (5th edn, C.H. Beck, München, 2008), Grundlagen para.204/205.

Loschelder in: Schmidt: *EStG* (33.edn, C.H. Beck, München, 2014)

M.Helminen: *EU Tax Law – Direct Taxation 2013* (2013 Edition, IBFD, 2013)

S. Douma: *Legal Research in International and EU Tax Law (*Kluwer, Deventer, 2014).

Journal Articles

A.Cloer and T.Hagemann, 'Federal Tax Court Holds Treaty Override Unconstitutional', (2014) European Taxation, p.510

C. de Pietro, ‚Tax Treaty Override and the Need for Coordination between Legal Systems: Safeguarding the Effectiveness of International Law'(2015) Volume 7 No.1 World Tax Journal.

C. Kahlenberg, ‚German Treaty Override Violates Constitutional Law', (2014) Bulletin for International Taxation, p. 480

C. Schmidt, ‚Sondervergütung auf Abkommensebene – Was nun, Finanzverwaltung und Gesetzgeber? Zugleich Anmerkung zum BFH Urteil vom 8.9.2010, I R 74/09', (2010) DStR, p.2436

D. Gosch, ‚Über das Treaty Overriding - Bestandsaufnahme – Verfassungsrecht – Europarecht' (2008) IStR , p.413

G. Frotscher, ‚Treaty Override und § ESTG § 50d Abs. 10 EStG' (2009) IStR, p.593

J.Bron, ‚Das Treaty Override im deutschen Steuerrecht vor dem Hintergrund aktueller Entwicklungen' (2007) IStR, p.431

L. Schoueri, ‚Tax Treaty Override: A Jurisdictional Approach‘(2014) Volume 42 Intertax, p.682

M. Lang, ‘The Procedural Conditions for the Implementation of Tax Treaty Obligations under Domestic Law’ (2007) Volume 35 Issue 35, Intertax, p. 146

M. Lehner, ‚Treaty Override im Anwendungsbereich des §50d EStG‘ (2012) IStR, p.389

R. Ismer and S. Baur, ‚Verfassungsmäßigkeit von Treaty Overrides‘ (2014) IStR, p.421.

S. Kielmansegg Graf, ‚Die Grundrechtsprüfung‘ (2008) Jus, p.23

S. Sachdeva, ‚Tax Treaty Overrides: A Comparative Study of the Monist and the Dualist Approaches’ (2013) Volume 41 Issue 4 Intertax, p. 180

V. Englmair, ‘The Relevance of the Fundamental Freedoms for Direct Taxation’, in M.Lang/P.Pistone/J.Schuch/C.Staringer: *Introduction to European Tax Law on Direct Taxation* (3rd Edition, Linde, Wien, 2012), p.46

W.Kessler and R.Eicke, ‘German Treaty Overrides: Contractual Duties Meet Fiscal Interests’ (2010) Tax Notes International, p.41

Documents

Bericht des Finanzausschusses zum JStG 2009, BT-Drs. 16/11108

BT Drucksache 16/10189, Entwurf eines Jahressteuergesetzes 2009 (2009), 02.09.2008

DTC between Germany and Italy from 1989 found in Bundesgesetzblatt, Jahrgang 1990, Teil 2

OECD Commentary

OECD Model Tax Convention 2014

OECD, ‘Tax Treaty Override’ *(adopted by the OECD Council on 2 October 1989)*

OECD: ‘The Application of the OECD Model Tax Convention to Partnerships’, (1999) Issues in International Taxation No. 6.

Vienna Convention on the Law of Treaties (1969)

Table of Cases

European Court of Justice

Case C-324/00 Lankhorst-Hohorst, ECLI:EU:C:2002:749, 12.12.2002

Case C-196/04 Cadbury Schweppes, ECLI:EU:C:2006:544, 12.12.2006

Case C-298/05, Columbus Container Services B.V.B.A & Co. v Finanzamt Bielefeld-Innenstadt, ECLI:EU:C:2007:754, 06.12.2007

German Cases

BVerfG 2 BvL 6/59 – 19.12.1961 in BVerfGE 13, 261

BVerfG 2 BvR 225/69 – 09.06.1971, in BVerfGE 31, 145

BVerfG 2 BvR 882/97 – 03.12.1997 in BVerfGE 97, 67

BVerfG 2 BvR 1481/04 – 14.10.2004 in BVerfGE 111, 307

BVerfG 2 BvR 2194/99 - 18. 1. 2006, para. 35, in DStR 2006, 555.

BFH I R 120/93 – 13.07.1994 in BStBl II 1995, 129

BFH I R 1/04 – 14.03.2006 in BStBl II 2006, 549

BFH I R 5/06 – 17.10.2007 in BStBl II 2009, 356

BFH I B 92/08 23.09.2008 in BStBl II 2009, 524

BFH IR 4/13 – 11.12.2013 in NJW 2014, 1264

FG München 1 K 1816/09 - 30. 7. 2009 in EFG 2009, 1954, appealed at the BFH I R 74/09