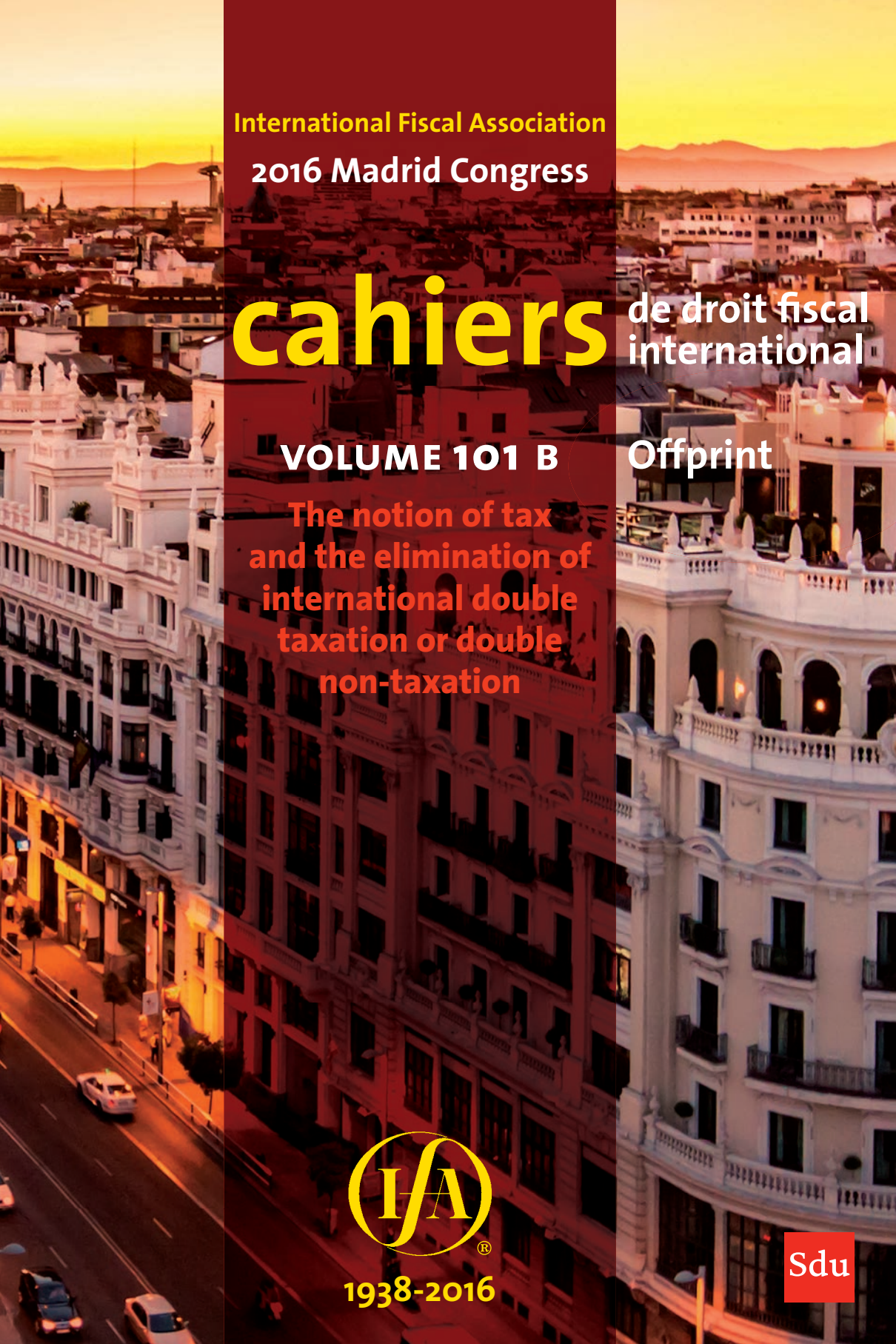

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The notion of tax and the elimination of international double taxation or double non-taxation

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Branch Reporters
Birgit Weitemeyer*
Götz T. Wiese**

Summary and conclusions

Section 3(1) Fiscal Code (*Abgabenordnung* (AO)) contains the domestic definition of tax (*Steuer*). Taxes are pecuniary payments that are not made as remuneration for a specific performance, but are imposed by a community under public law for the purpose of generating public income. Fees (*Gebühren*) and dues (*Beiträge*) are not taxes because they are charged as remuneration for specific services (fees) or for the possibility of claiming a benefit (dues). Special levies (*Sonderabgaben*) and social insurance contributions (*Sozialversicherungsbeiträge*) do not constitute taxes because they do not cover general public financial needs but are used to finance specific projects/funds. Fines (*Geldbussen* and *Geldstrafen*) also do not constitute taxes because they (likewise) are not meant to generate public income but are payment obligations imposed as penalties.

According to section 2(4) Income Tax Act (*Einkommensteuergesetz* (EStG)) income is the sum of earnings after certain personal expenses. Section 2(1) EStG lists seven sources of earnings. Any profit/gain that cannot be allocated to one of the sources listed by section 2(1) EStG is deemed non-taxable for income tax purposes. The Corporate Income Tax Act (*Körperschaftsteuergesetz* (KStG)) has no independent definition of income but refers to the EStG. Germany currently does not impose a tax on capital.

Sections 34c EStG, 26 KStG contain unilateral regulations for the elimination of double taxation (credit and deduction method). A foreign levy can only be credited/deducted if it is a tax within the meaning of section 3(1) AO. In addition, the foreign levy has to correspond more closely to German income or corporate tax than to any other German levy.

It is controversial whether the concept of tax in a tax treaty is to be construed by reference to section 3(1) AO or autonomously. However, both approaches come to the same conclusion. The terms income and capital have to be construed autonomously when the application of a tax treaty is concerned. Income is described by articles 6–21 OECD model tax convention (MTC) and capital is described by article 22 OECD MTC.

* Prof. Dr., holds the Chair of Tax Law at Bucerius Law School, Hamburg; Director of the Institute for Foundation Law and the Law of Non-Profit Organizations

** Dr., specialized tax lawyer (*Fachanwalt für Steuerrecht*); Tax advisor (*Steuerberater*) resident in the City of Hamburg; Lecturer (*Lehrbeauftrager*) for tax law at Bucerius Law School, Hamburg

In order to establish residence (article 4 OECD MTC), the taxpayer has to be liable to a tax covered by the treaty based on the criteria set out in article 4(1) sentence 1 OECD MTC; there usually has to be full tax liability on worldwide income. To be deemed a resident of Germany, a taxpayer has to be fully liable to income tax according to section 1(1) and(2) EStG or corporate income tax according to section 1(1) KStG; a minimum tax payment is not required for being considered a resident. Furthermore, even personal or objective tax exemptions are irrelevant.

If the exemption method is applicable, foreign income is exempted from the assessment basis for German taxes on income (*Einkommensteuer*, *Körperschaftsteuer*, *Gewerbesteuer*). Exemption from the assessment basis also means that positive foreign income cannot be offset against negative domestic income (and vice versa according to prevailing opinion). However, foreign income is taken into consideration in determining the tax rate (progession proviso). Furthermore, although foreign income is exempt from tax, the authority to collect duties that are not covered by the tax treaty remains unaffected.

If the tax treaty provides for the credit or deduction method, sections 34c EStG, 26 KStG are applicable. Foreign duties can be offset if they are taxes covered by the tax treaty. Crediting/deducting requires that the foreign tax has actually been paid. However, "paid" does not refer to a specific performance procedure. Rather, it is sufficient that – economically speaking – a tax has been discharged.

German tax treaties increasingly include subject-to-tax clauses. Usually these clauses make the exemption method dependent on taxation of income in the country of source. The precise requirements that have to be met for the subject-to-tax clause to be ineffective depend on the wording of the clause. If it only requires income to be "subject to taxation" or "taxable", the existence of tax liability regarding a tax subject to the tax treaty is sufficient and tax exemptions are irrelevant. In all other cases income must have actually been taxed, i.e. foreign income has to be taken into consideration in determining the assessment basis for a tax subject to the tax treaty; personal and objective tax exemptions as well as taxation omitted due to factual reasons (e.g. ignorance of the tax authorities) result in "non-taxation" with regard to the subject-to-tax clause.

Domestic law increasingly contains provisions that are designed to prevent double non-taxation or taxation at low rates. First of all, there is the controlled foreign company (CFC) regime of sections 7 *et seq*. of the Foreign Transaction Act (*Aussensteuergesetz* (AStG)). CFC rules apply if there is low taxation abroad; according to section 8(3) AStG taxation is low if the (income) tax burden on passive income amounts to less than 25 per cent (the assessment basis to be determined in accordance with German tax law). Section 20(2) AStG provides for a switch-over from the exemption method to the credit method for income generated by a foreign permanent establishment if CFC rules were applicable in the case of a CFC instead of the permanent establishment.

In addition, section 50d(9) EStG contains two switch-over clauses. First, the credit method is applicable if the country of source (erroneously) implements the tax treaty in a way that results in non-taxation or taxation at a reduced rate. Second, the credit method is applicable if the country of source does not assess tax because the taxpayer has no full tax liability due to lack of residence in that country. Furthermore, section 50d(8) EStG contains a subject-to-tax clause that requires the

taxpayer to prove that foreign income tax on employment has been paid or that the other state has waived its right to impose taxes.

The general anti-abuse regulation of section 42 AO also applies in cross-border matters. However, for the application of section 42 AO the level of taxes paid abroad is irrelevant.

Most of the domestic anti-abuse regulations are applicable in tax treaty constellations. This effect is known as treaty overriding. The Federal Constitutional Court (*Bundesverfassungsgericht*) will soon decide on the constitutionality of treaty overriding.

1. The notion of tax

1.1. Domestic law meaning of tax

1.1.1. Conceptual characteristics of taxes

According to the legal definition of section 3(1) half sentence 1 Fiscal Code (AO) taxes are pecuniary payments that are not made as remuneration for a specific performance, but are imposed by a community under public law for the purpose of generating public income from all those required by law to make payment.[1]

The German Constitution (*Grundgesetz* (GG)) does not provide a legal definition of tax. According to settled case law, the Federal Constitutional Court (*Bundesverfassungsgericht* (BVerfG)) assumes the Constitution follows the AO with regard to the term "tax", without being bound by amendments to the AO.[2]

The term "taxes" includes income tax (*Einkommensteuer*) and corporate income tax (*Körperschaftsteuer*), together with any additional duties.[3] It also includes trade tax (*Gewerbesteuer*), capital tax (*Vermögensteuer*),[4] real estate tax (*Grundsteuer*), inheritance and gift tax (*Erbschaft- und Schenkungsteuer*), transaction taxes,[5] excise taxes[6] and expenditure taxes.[7] Under section 3(3) AO, the import and export duties provided by articles 4 Nos. 10 and 11 of the Customs Code (*Zollkodex*) also constitute taxes.[8]

1 It is disputed whether the last characteristic ("from all those required by law to make payment") is part of the definition of taxes or a prerequisite for legality, see Wernsmann in Hübschmann, Hepp and Spitaler, AO/FGO, s. 3 AO, ann. 184 *et seq*. with further references.

2 See Federal Constitutional Court, 6 November 1984, 2 BvL 19/83, *Bundessteuerblatt* (1984) Part II, p. 858.

3 Currently solidarity surcharge.

4 See Federal Constitutional Court, 22 June 1995, 2 BvL 37/91, *Bundessteuerblatt* (1995) Part II, p. 655. Capital tax has not been levied since 1997.

5 Examples are sales tax (*Umsatzsteuer*), insurance tax (*Versicherungsteuer*) and real estate transfer tax (*Grunderwerbsteuer*).

6 Examples are beer tax (*Biersteuer*), energy tax (*Energiesteuer*), electricity tax (*Stromsteuer*), tobacco tax (*Tabaksteuer*). In economic terms, sales tax is also an excise tax, since it usually only affects the end consumer.

7 Examples are dog tax (*Hundesteuer*) and taxes on second homes (*Zweitwohnungsteuer*).

8 See also art. 106(1) No. 1 GG.

Special levies (*Sonderabgaben*) are closely related to taxes. They differ from taxes in that they do not cover general public financial needs, but rather are used to finance specific projects. In other words, the revenue from special levies (*Sonderabgaben*) is reserved for a special fund.[9] Examples include levies for bank deposit protection funds or commercialisation funds in agriculture.

As an example, the Wine Trade Act of 29 August 1961 provides for a wine stabilisation fund which imposes levies on owners or holders of rights of use of vineyards, as well as commercial buyers of wine and its raw materials. The amount collected is calculated based on acreage of the vineyard or the amount of product acquired. The purpose of the fund is to improve wine quality, promote advertising for wine, reduce loan prices for wine makers and wine trading companies, and store, purchase or utilise domestically produced wine, if this should be necessary to relieve the market, and to utilise it. The BVerfG defined this levy not as a tax, but as a special levy (*Sonderabgabe*), whose legitimacy is subject to different criteria from taxes.[10]

Fees (*Gebühren*) and dues (*Beiträge*) are not taxes, since they are charged as remuneration for specific services (fees) or for the possibility of claiming a benefit (dues).[11] Accordingly, broadcasting contributions, which were instituted in 2013 to finance public broadcasting companies, are dues (*Beiträge*) because they are not imposed on all inhabitants, but only on the owners of residences able to receive broadcasts.

Social insurance contributions (*Sozialversicherungsbeiträge*) do not constitute taxes, since the benefit accrues only to the person subject to the contributions and the revenues do not serve to finance the general budget.[12] Fines (*Geldbussen* und *Geldstrafen*) likewise do not generate public income but are payment obligations imposed as penalties.[13]

1.1.2. Tax on income and capital

There is no abstract definition of the term "income" in the Income Tax Act (EStG). Rather, income is the result of a multistage arithmetic operation that is based on the types of earnings as defined in section 2(1) sentence 1 Nos. 1–7 EStG.[14] Therefore, the German income tax neither explicitly follows source theory, net asset gain theory nor market income theory, but rather takes a pragmatic approach to income taxation.[15] Further, since income (as this term is used here) is used as the basis of assessment, the German income tax and corporate tax are taxes on income.

It is contested whether trade tax (*Gewerbesteuer*) also constitutes a tax on income.[16] Some argue that trade tax does not constitute a tax on income because

9 Federal Constitutional Court, 9 November 1999, 2 BvL 5/95, *Bundesgesetzblatt* (2000) Part I, p. 53; Wernsmann, *op. cit.*, ann. 225 *et seq.*

10 Federal Constitutional Court, 5 March 1974, 1 BvL 27/72, *Entscheidungen des Bundesverfassungsgerichts* (BVerfGE) 37, p. 1.

11 Wernsmann, *op. cit.*, ann. 150 *et seq.*, 270 *et seq.*

12 *Ibid.*, ann. 133, 313 *et seq.*

13 *Ibid.*, ann. 128.

14 Once these earnings have been summarised into a sum of earnings, personal expenses are taken into account, see s. 2(3-5) EStG.

15 Musil in Herrmann, Heuer and Raupach, EStG/KStG, s. 2 EStG, ann. 10.

16 See Wernsmann, *op. cit.*, ann. 373 *et seq.*

pursuant to section 2(1) sentence 1 Trade Tax Act (*Gewerbesteuergesetz* (GewStG)) trade tax is not levied on a person's income or assets, but rather on the business establishment itself (*stehender Gewerbetrieb*) irrespective of who the owner is (a so-called object tax, section 3(2) AO). Furthermore, trade taxes are not included in the deduction prohibitions stated in sections 12 No. 3 EStG, 10 No. 2 Corporate Income Tax Act (KStG).[17] Logical interpretation leads us to this conclusion, because any alternative interpretation of the phrase "other taxes on persons" would not be grammatically consistent. Moreover, any alternative interpretation would not be logically consistent with the special prohibition of deduction as specified in section 4(5b) EStG and tax reduction in terms of section 35 EStG. Others argue in favour of classifying the trade tax as a tax on income because pursuant to section 7 sentence 1 GewStG, the origin of the assessment basis is the profit from business operations as determined by the provisions of EStG or KStG.

The method for determining earnings (and therefore income as described in section 2 EStG) depends on the type of the taxpayer's earnings. It is determined by either calculating profit or income surplus after professional expenses. Generally, the net principle and realisation principle apply.[18] However, the EStG also recognises deviating methods of earnings calculation. Section 5a EStG, for example, provides for profit determination for merchant vessels in international trade based on tonnage. Deviating methods of calculating income are also available to small enterprises in agriculture and forestry in accordance with section 13a(3-6) EStG.

Taxes on capital are taxes that are not assessed on the basis of income but on existing assets. In Germany, this category currently includes real estate tax (*Grundsteuer*) and capital tax (*Vermögensteuer*), the latter not having been imposed since 1997.

Classification of inheritance and gift taxes within the German tax system is disputed. The Federal Fiscal Court (*Bundesfinanzhof* (BFH)) classifies inheritance tax as a transaction tax.[19] Others are discussing changing the classification to a tax on income.[20] As provided under section 1(1) Nos. 1–3 Inheritance and Gift Tax Act (*Erbschaft- und Schenkungsteuergesetz* (ErbStG), inheritance and gift taxes cover acquisitions through gratuitous transfer.[21]

The envisaged tax on financial transactions would be classified as a transaction tax should it be introduced in Germany.[22]

1.1.3. The concept of tax in the context of unilateral regulations for the elimination of double taxation

Sections 34c EStG, 26 KStG contain unilateral regulations for the elimination of double taxation. A foreign tax may only be offset against income tax (or corporate

17 Heger in Gosch, KStG, s. 10, ann. 26.

18 See Musil, *op. cit*., ann. 12 and 503.

19 See Federal Fiscal Court, 30 November 2011, II B 60/11, *Deutsches Steuerrecht* (2012), p. 1652 with further references.

20 Gebel in Troll, Gebel and Jülicher, ErbStG, introduction, ann. 1 *et seq*., 15 *et seq*.

21 S. 1(1) No. 4 ErbStG regulates inheritance tax for the assets of family foundations and family associations.

22 For the so-called Tobin tax as a transaction tax on exchange transactions, see T. Vogel, *Internationales Steuerrecht* (2012), p. 12, with reference to Tobin, *Eastern Economic Journal* (1978), p. 153.

tax), if it is equivalent to German income or corporate tax. First, the foreign duty has to be a tax within the meaning of section 3(1) half sentence 1 AO. Second, the structure of the foreign duty has to correspond more closely to German income or corporate tax than to any other German duty. The crucial point of comparison is the taxable object; tax rate, type of tax collection and designation are irrelevant.[23] For example, the Brazilian *imposto de renda da pessoas fisicais* is seen, by the tax authorities, as the equivalent of German income tax.[24]

To be eligible for set-off, the foreign tax must have been determined and paid. Determination presumes that tax liability is assessed by official means or by tax return if it is a withholding tax, as the case may be. A tax is deemed paid when it has been satisfied by payment or other transaction in accordance with sections 224 *et seq*. AO, e.g. by set-off.[25]

The maximum amount of foreign taxes that can be offset under section 34c(1) EStG is determined by applying the average German tax rate of the taxpayer on the foreign income. Former regulations for the maximum offsettable amount did not take into account any personal deductions[26] to be taken from total income, which resulted in a lower maximum offsettable amount. This was deemed by the European Court of Justice to be incompatible with the free movement of capital in terms of article 64 of the Treaty on the Functioning of the European Union (TFEU). According to the European Court of Justice, freedom of capital requires the state of residence to grant the taxpayer all the tax allowances relating to his personal and family circumstances.[27]

On the other hand, the per country limitation, as set out in section 34c(1) EStG and as defined in section 68a sentence 2 Income Tax Implementing Regulations (*Einkommensteuer-Durchführungsverordnung* (EStDV)), does not violate freedom of capital. It may result in potential losses in one country becoming ineligible to offset positive income in another, but this procedure is justified by the necessity of maintaining a balanced distribution of taxation competences among the Member States, i.e. the principle of territoriality.[28]

1.2. Taxes covered by German tax treaties

1.2.1. The concept of tax in article 2 OECD MTC

According to article 2(1) OECD MTC, the tax treaty applies to taxes on income and on capital imposed on behalf of a contracting state or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

23 Wagner in Blümich, *EStG/KStG/GewStG*, s. 34c EStG, ann. 28; Federal Fiscal Court, 27 March 1996, I R 49/95, *Bundessteuerblatt* (1997) Part II, p. 91.

24 See EStG regulations, annex 12 II.

25 Kuhn in Herrmann, Heuer and Raupach, EStG/KStG, s. 34c EStG, ann. 71 *et seq*.

26 Proportional tax allowances for elderly retired persons, special expenses, insurance contributions and minimum exempted income.

27 European Court of Justice, 28 February 2013, C-168/11, *Bundessteuerblatt* (2015) Part II, p. 431.

28 Federal Fiscal Court, 18 December 2013, I R 71/10, *Bundessteuerblatt* (2015) Part II, p. 361.

In Germany, it is controversial whether the concept of tax in a tax treaty is to be construed by reference to national law[29] or autonomously.[30] When construed autonomously, the result is that there has to be a pecuniary consideration[31] and that the payment has to be made for the benefit of the state budget.[32] Further, the payment has to be non-voluntary[33] and must not be made as remuneration for a specific service.[34] As a result, the notion of tax as seen in accordance with an autonomous interpretation does not differ from the notion of national tax.[35]

It is also disputed whether duties or charges accessory to taxes, such as delay payments, default fines and interest (see section 3(4) AO), are taxes in the context of a tax treaty. Reference is made to note 4 of the commentary on article 2 OECD MTC.[36] However, the note is ambiguous. On the one hand, it says that the country authorised to levy taxes may levy "taxes … together with any duties or charges accessory to them", potentially supporting the view that additional duties are taxes. On the other hand, the German version of the commentary states "that the same provisions apply to the levying of additional duties as to the original tax itself", making it possible to conclude that accessory duties/charges are not considered taxes. The most compelling argument against the classification of accessory duties/ charges as a tax is that they are not levied for the purpose of generating income, but are paid as a fee or fine.[37] However, it is agreed that the country authorised to levy taxes under the tax treaty may also impose accessory duties/charges.[38] Differences occur in the recognition of foreign accessory duties/charges when applying the credit method.[39]

It is unanimously agreed that penalties and fines imposed as a result of tax offences or tax infringements are not taxes in terms of tax treaties.[40] Since the autonomous interpretation does not differ from the domestic notion of tax, social security contributions, fees (*Gebühren*), dues (*Beiträge*) and special levies (*Sonderabgaben*) are not subject to the tax treaties, either.[41]

There are two tax collection methods in German tax law: the assessment procedure[42] (*Veranlagung*) and tax deduction at source[43] (*Quellensteuer*). Processing through a payment debtor as "paying agent" is only a special form of collection and still means that the tax burden is borne by the person receiving the income.[44]

29 In combination with art. 3(2) OECD MTC.

30 For range of opinions see Wassermeyer and Kaeser in Wassermeyer, DBA, art. 2 OECD MTC, ann. 26 with further references.

31 This results from the wording of art. 23B(1) and art. 27(2) OECD MTC, which features the words "amount" and "paid"; see Ismer in Vogel and Lehner, DBA, art. 2, ann. 26.

32 See wording art. 2(1) OECD MTC: "imposed on behalf of a Contracting State".

33 This can be concluded based on the phrasing "imposed" in art. 2(1) OECD MTC; see Ismer, *op. cit*., ann. 26, reference is also made to the French phrasing (*établis*).

34 See OECD commentary on art. 2 OECD MTC, ann. 3 sentence 4; Ismer, *op. cit*., ann. 26.

35 See only Wassermeyer and Kaeser, *op. cit*., ann. 26.

36 Ismer, *op. cit*., ann. 28.

37 Dremel in Schönfeld and Ditz, DBA, art. 2, ann. 23 with further references.

38 See OECD commentary on art. 2 OECD MTC, ann. 4; see Wassermeyer and Kaeser, *op. cit*., ann. 51.

39 Kuhn, *op. cit*., ann. 62.

40 Wassermeyer and Kaeser, *op. cit*., ann. 26.

41 Ismer, *op. cit*., ann. 30; Dremel, *op. cit*., ann. 20.

42 The assessment procedure is the default method, ss. 25(1) EStG, 31(1) sentence 1 KStG.

43 Deduction at source is the exception, but is of considerable practical importance nonetheless.

44 See Dremel, *op. cit*., ann. 14.

Tax may be imposed on behalf of a contracting state or of its political subdivisions or local authorities, provided the contracting state or one of its political subdivisions holds tax sovereignty for the tax in question.[45] Whether the respective political subdivision in the contracting state is a local authority has to be determined in accordance with the legislation of the contracting state.[46] Therefore, the German church tax (*Kirchensteuer*) is not subject to the tax treaties, since churches are statutory bodies under public law, but are not local authorities.[47]

1.2.2. Taxes on income and capital in terms of article 2 OECD MTC

The terms income and capital have to be construed autonomously.[48] As such, articles 6–21 OECD MTC are controlling in the case of income and article 22 OECD MTC in the case of capital. The actual type of assessment of income, based on, for example, the gross or net principle[49] or even alternative methods such as tonnage,[50] is inconsequential in this regard. Realisation of income by external sales is irrelevant as well.[51]

A tax imposed on capital acquired by gratuitous transfer (e.g. transfer by death or transfer by gift) does not constitute a tax on income, therefore the tax treaty does not apply.[52] However, should a gratuitous donation lead to income under articles 6–21 OECD MTC and national law, the resulting tax on income would be subject to the tax treaty.[53] In Germany, this particularly applies to gratuitous contributions to a business, provided that they are not capital contributions.[54] According to the latest jurisprudence, income tax/corporate tax and inheritance/gift tax are to be mutually exclusive.[55] Section 7(1) No. 1 ErbStG stipulates that any contribution between living persons constitutes a gift, provided that the contribution enriches the beneficiary at the expense of the person making the contribution. The ErbStG does not apply to pecuniary benefits the taxpayer gains by generating income from the gift, which the taxpayer will therefore have to pay income tax on. In this case, the requirement of generosity is not met.

45 Correspondingly, this applies to the federal government, federal states, municipalities and municipal associations in Germany, see art. 106 GG.

46 Wassermeyer and Kaeser, *op. cit.*, ann. 20.

47 Ismer, *op. cit.*, ann. 13.

48 Wassermeyer and Kaeser, *op. cit.*, ann. 29.

49 See Wassermeyer and Kaeser, *op. cit.*, art. 10 OECD MTC, ann. 113, and art. 13 OECD MTC, ann. 44; Ismer, *op. cit.*, ann. 34.

50 Wegner in Strunk, Kaminski and Köhler, AStG/DBA, art. 8 OECD MTC, ann. 34 *et seq.*

51 See OECD commentary on art. 13 OECD MTC, ann. 7, 8 and 9; Wassermeyer and Kaeser, *op. cit.*, art. 13 OECD MTC, ann. 26 *et seq.*

52 Ismer, *op. cit.*, ann. 36.

53 See Meincke in Meincke, ErbStG, introduction, ann. 2; critically assessed by Geck in Kap and Ebeling, ErbStG, introduction, ann. 14 *et seq.*

54 Transfer of co-owner's share of a flat by client to lawyer, Fiscal Court Münster, 26 February 2014, 7 K 1183/10 U,F, *Entscheidungen der Finanzgerichte* (2014), p. 1970.

55 Federal Fiscal Court, 12 September 2011, VIII B 70/09, *DStR-Entscheidungsdienst* (2012), p. 154; Federal Fiscal Court, 27 August 2014, II R 43/12, *Bundessteuerblatt* (2015) Part II, p. 241, ann. 10; see also Krieg, *Gesellschaften als Erben* (2013); left open in case of transfer to retirement home operator by Federal Fiscal Court, 14 March 2006, VIII R 60/03, *Bundessteuerblatt* (2006) Part II 2006, p. 650.

In addition to inheritance and gift taxes,[56] transaction taxes and excise taxes, especially sales tax, are not subject to tax treaties.

1.2.3. Importance of article 2(3) OECD MTC

Article 2(3) OECD MTC contains a non-exhaustive list of taxes that are subject to the tax treaty. According to prevailing opinion, article 2(3) may broaden the range of levies subject to the treaty, i.e. include them in the scope of the treaty by designating otherwise non-tax levies or non-income taxes under article 2(1) and (2) OECD MTC as taxes on income or capital.[57]

The provision in German tax treaties that corresponds to article 2(3) OECD MTC always includes income tax (*Einkommensteuer*), corporate tax (*Körperschaftsteuer*) and trade tax (*Gewerbesteuer*). Additionally, the majority of German tax treaties also contain references to surcharges.[58] Even though not explicitly mentioned, the surcharges (currently solidarity surcharge – *Solidaritätszuschlag*) are treated as taxes on income.[59] Usually capital tax (*Vermögensteuer*) is included as well, whereas real estate tax (*Grundsteuer*) is rarely included,[60] since most countries base real estate tax obligations on the location of the property, thus generally avoiding the double taxation issue.[61]

At the moment, there is no German tax on income or capital that is not listed in German tax treaties (in the provision corresponding to article 2(3) OECD MTC). However, the re-introduction of the capital tax (*Vermögensteuer*) or of a one-off levy on capital (*einmalige Vermögensabgabe*) is currently being debated.[62]

1.2.4. Application scenarios for article 2(4) OECD MTC

Currently, no German taxes are covered by article 2(4) OECD MTC. To determine whether there is sufficient similarity for the purposes of article 2(4) OECD MTC a complete comparison of the elements of both taxes must be undertaken. Here, the entire tax system of a country has to be taken into consideration.[63]

1.2.5. "Tax" and "taxation" in other articles of the OECD MTC

When the terms "taxation"[64] or "taxed"[65] are used in a tax treaty, the reporters view this to mean that the requirements for a tax of article 2 OECD MTC apply.

56 With regard to inheritance and gift taxes, Germany has concluded separate treaties with four countries. Additionally, two tax treaties contain provisions regarding income/capital and inheritance/gift tax; see *Bundessteuerblatt* (2015) Part I, p. 128.
57 Ismer, *op. cit.*, ann. 51; Wassermeyer and Kaeser, *op. cit.*, art. 2 OECD MTC, ann. 56.
58 See overview in Ismer, *op. cit.*, ann. 53.
59 Wassermeyer and Kaeser, *op. cit.*, ann. 12 and 57.
60 See overview in Ismer, *op. cit.*, art. 2, ann. 53.
61 Dremel, *op. cit.*, ann. 36.
62 See Scheffler, *Deutsches Steuerrecht* (supplementary booklet 2013), p. 51.
63 Ismer, *op. cit.*, ann. 61; Wassermeyer and Kaeser, *op. cit.*, art. 2 OECD MTC, ann. 68 and 70.
64 For example in art. 23A(1) OECD MTC.
65 For example in art. 7(1) OECD MTC.

Therefore, "taxes" as used in other articles of the OECD MTC must be taxes on income or capital.

2. The concept of tax in terms of eliminating double taxation

2.1. Tax treaty resident concept

2.1.1. Requirements for establishing residence

In terms of article 4(1) sentence 1 OECD MTC, a person is a resident of a contracting state if the person is liable to tax under the law of that state due to domicile, residence, place of management, or a similar characteristic. National law decides on the interpretation of the stated characteristics and the existence of tax liability.[66] Full tax liability on worldwide income, based on the characteristics listed in article 4(1) sentence 1 OECD MTC, is usually a requirement for establishing residence within the meaning of the OECD MTC. It can be deduced from article 4(1) sentence 2 OECD MTC that partial tax liability is not sufficient.[67] Diverging provisions only apply if the jurisdiction does not recognise tax liability on worldwide income, but instead in accordance with the principle of territoriality.[68]

Residence can only be established for treaty purposes if there is full tax liability regarding a tax covered by the tax treaty.[69] As a result, only full income tax liability in terms of section 1(1 and 2) EStG[70] as well as full corporate tax liability in terms of section 1(1) KStG are considered for the purposes of establishing residence in Germany. Further, due to the transparent taxation of partnerships in accordance with section 15(1) sentence 1 No. 2 sentence 1 EStG, a partnership cannot be a resident of Germany. Thus, a partnership cannot be protected by the treaty; however, the partners can be protected by the tax treaty.[71] According to prevailing opinion, mere trade tax liability of a partnership is not sufficient to establish residence, since only the domestic business itself[72] is subject to trade tax. A partnership is therefore only liable for taxes derived from specific sources in the meaning of article 4(1) sentence 2 OECD MTC.[73]

In principle, the mere possibility of being subject to personal tax liability is sufficient to be deemed a resident in Germany; no minimum tax payment is necessary.

66 Wassermeyer and Kaeser, *op. cit.*, art. 4 OECD MTC, ann. 8, 31 *et seq.*; Lehner in Vogel and Lehner, DBA, art. 4, ann. 90.

67 Wassermeyer and Kaeser, *op. cit.*, art. 4 OECD MTC, ann. 2, 29, 45; Lehner, *op. cit.*, ann. 77.

68 See OECD commentary on art. 4 OECD MTC, ann. 8.3.

69 Lehner, *op. cit.*, ann. 77; Wassermeyer and Kaeser, *op. cit.*, art. 4 OECD MTC, ann. 29.

70 Wassermeyer and Kaeser, *op. cit.*, art. 4 OECD MTC, ann. 43; Lehner, *op. cit.*, ann. 120.

71 OECD Partnership Report 1999.

72 There is no full or partial tax liability based on one of the characteristics of art. 4 OECD MTC in GewStG.

73 On prevailing opinion, see Wassermeyer and Kaeser, *op. cit.*, art. 4 OECD MTC, ann. 25, 46; for a different opinion, see High Court of Judicature (Mumbai), 8 January 2013, Income Tax Appeal No. 2273 of 2010; Jacob and Hagena, *Internationales Steuerrecht* (2013), p. 485.

It is widely disputed whether personal tax exemption – e.g. in terms of sections 5 KStG, 11(1) sentence 2 Investment Tax Act (*Investmentsteuergesetz* (InvStG)) or 16(1) Real Estate Investment Trust Act (*Gesetz über deutsche Immobilien-Aktiengesellschaften mit börsennotierten Anteilen* (REITG)) – results in a finding of non-residence. An argument in favour of this view is that there is no obligation to pay tax when there is full personal tax exemption.[74] However, a more compelling argument against this view is that, despite the tax exemption, a fundamental tax liability exists under section 1(1) KStG. Additionally, differentiating between personal and objective tax exemptions would be inconsistent because the question of residence and, consequently, application of the tax treaty, would be dependent on technical coincidences of national tax law.[75] Finally, against this view one can also make the point that there are partial personal exemptions but there is no concept of partial residence.[76]

German law does not include an anti-abuse provision that negates residence of a taxable entity in another contracting state. However, the fiscal existence of a foreign (non-transparent) company may be disregarded under section 42 AO, so that for the purposes of German taxation, the income generated by the company will be attributed to the shareholders irrespective of the residence of the company, if the company serves no economic or otherwise notable purpose.

2.1.2. Conflict resolution mechanisms regarding residence

Whether a taxpayer qualifies for residence in a contracting state depends on the national law of that contracting state (see above). In case of double residence, article 4(2 and 3) OECD MTC (so-called "tie-breaker rules")[77] are controlling.

As an example, a taxpayer with a family home in Austria had domestic income from employment in Germany that was taxable in Germany in accordance with the Germany–Austria tax treaty. Since the taxpayer also had a home in France, he qualified as a cross-border commuter and his German income was thus taxable only in France according to the Germany–France tax treaty, despite France waiving taxation in favour of Austria, in accordance with the tie-breaker rule. However, the tie-breaker rule only has bilateral effects, i.e. no overall centre of vital interests is determined,[78] so whether taxation reverts to Austria in this case could be disputed.[79]

If tie-breaker rules do not yield an unambiguous answer, the responsible authorities of the contracting states will settle the question of residence by mutual consent. Should disputes arise in determining residence pursuant to article 4(1) OECD MTC or in applying the tie-breaker rules (e.g. because Germany concludes, under

74 Fiscal Court Lower Saxony, 29 March 2007, 6 K 514/03, *Entscheidungen der Finanzgerichte* (2007), p. 1223.

75 Wassermeyer and Kaeser, *op. cit*., art. 4 OECD MTC, ann. 25 *et seq*.; Lehner, *op. cit*., ann. 83 *et seq*.

76 Pohl in Schönfeld and Ditz, DBA, art. 4, ann. 25.

77 Wassermeyer and Kaeser, *op. cit*., art. 4 OECD MTC, ann. 51.

78 Federal Fiscal Court, 4 November 2014, I R 19/13, *Internationales Steuerrecht* (2015), p. 142; for a different view see Wassermeyer, *Internationales Steuerrecht* (2015), p. 144.

79 According to Gosch, *NWB Internationales Steuer- und Wirtschaftsrecht* (2015), p. 112, the reversion clause of art. 15(4) tax treaty Austria would apply; for a different view see Lang, *Steuer und Wirtschaft International* (2015), p. 198 since income was "recorded for fiscal purposes" in Germany.

application of foreign law, that the person is not a resident of another country (or vice versa)), article 25 OECD MTC sets forth mutual agreement procedures for the disputing countries to follow.[80]

2.2. The methods for the elimination of international double taxation

2.2.1. General questions

For the purposes of the method articles, the concept of tax and taxation is of considerable importance. Under the exemption method (article 23A(1) OECD MTC), foreign income or foreign capital are to be exempted from "tax" in the country of residence. Under the credit method (article 23A(2) and article 23B OECD MTC), the amount corresponding to the "tax paid" in the foreign country has to be offset against the "tax" in the country of residence.

Article 23A/B OECD MTC is always addressed towards the country of residence, making its classification of the domestic/foreign duty as "tax on income/capital" the decisive factor. If the tax does not constitute a tax on income or capital from Germany's point of view, the tax treaty does not reduce the double financial burden. The unilateral credit mechanism of section 34c EStG (or in combination with section 26 KStG, as the case may be) does not apply if the foreign duty does not correspond to the German income or corporate tax.

2.2.2. Exemption method

The exemption method is the default method in German tax treaties.[81] Foreign income is exempted from the assessment basis for German taxes on income.[82] Thus, exemption from taxes under the tax treaty has the same effect as a tax exemption under section 3 EStG.[83]

Foreign income, however, is taken into consideration in determining the tax rate ("progression proviso" provided under section 32b EStG). This applies to both positive and negative foreign income.[84] Reference to the progression proviso is made in article 23A(3) OECD MTC and in article 22(1) No. 2 German model tax treaty.[85]

Since it is exempted from the assessment basis, positive foreign income will not be offset against negative domestic income.[86] It remains disputed whether this also applies in the opposite case – foreign losses and domestic profits. The prevailing opinion stresses the importance of symmetry in such treatment of exemptions and thus rejects set-off in this configuration.[87] According to the European Court of

80 See Wassermeyer and Kaeser, *op. cit*., art. 4 OECD MTC, ann. 34.
81 See overview in Ismer, *op. cit*., art. 23A, ann. 16.
82 The following explanations only cover income since Germany does not impose capital tax at present.
83 Wassermeyer in Wassermeyer, DBA, art. 23A OECD MTC, ann. 52.
84 *Ibid.*, ann. 121.
85 Regarding German tax treaty practice, see Ismer, *op. cit*., art. 23A, ann. 16.
86 *Ibid.*, ann. 49.
87 See Federal Fiscal Court, 26 February 2014, I R 56/12, *Bundessteuerblatt* (2014) Part II 2014, p. 703; Schönfeld and Häck in Schönfeld and Ditz, DBA, art. 23A, ann. 31 and 36; for a different view see Ismer, *op. cit.*, art. 23A, ann. 56 with further references.

Justice, freedom of capital, as set forth in article 64 TFEU, is another reason foreign losses should not be taken into account in the assessment basis, since such accounting would require reimbursement for an amount that originated in another Member State.[88] The situation is different if losses incurred abroad can definitely no longer be utilised (so-called "final" losses).[89]

The authority to collect social insurance contributions (*Sozialversicherungsbeiträge*), special levies (*Sonderabgaben*) and other duties that are not listed in the tax treaty remains unaffected by the exemption method.[90]

2.2.3. Credit method

The credit method is rarely applied as the default method in German tax treaties.[91] According to article 22(1) No. 3 German model tax treaty, the credit method is only used for a few types of income, including income from dividends which is not subject to the participation exemption.[92] Article 23A(2) and article 23B(1) OECD MTC and German tax treaties do not specify an independent credit mechanism, but instead defer to national law. Sections 34c EStG and 26 KStG allow for set-off against German income and corporate tax. Since Germany currently does not impose capital tax, a set-off mechanism for capital tax is not required.

The Trade Tax Act (*Gewerbesteuergesetz*) does not include a credit provision. Consequently, crediting foreign tax against German trade tax is regularly omitted in practice.[93] There is, however, particular need for such crediting if foreign taxes cannot be set off in full against income and corporate taxes. Those believing that set-off may or has to occur argue that the German tax treaties usually provide for offsets against all taxes on income and that trade taxes are to be classified as taxes on income by virtue of being included on a list corresponding to article 2(3) OECD MTC.[94] The opposing view states that German tax treaties usually contain wording to the effect that setting off "is subject to the provisions of German tax law",[95] and therefore crediting against trade tax requires a special credit provision in *GewStG*.[96]

88 European Court of Justice, 11 September 2014, C-47/12, *Internationales Steuerrecht* (2014), p. 724, ann. 83, for the comparison of the former crediting procedure in accordance with s. 8b(5) KStG 1994 for dividend payments in domestic cases under exemption method; order for reference of the Fiscal Court Cologne, 6 September 2011, 13 K 482/07, *Entscheidungen der Finanzgerichte* (2012), p. 973.

89 Federal Fiscal Court, 9 June 2010, I R 107/09, *Sammlung der Entscheidungen des Bundesfinazhofs* (BFHE) 230, p. 35; European Court of Justice, 15 May 2008, C-414/06, *Bundessteuerblatt* (2009) Part II, p. 692.

90 Ismer, *op. cit.*, art. 23A, ann. 42.

91 Default method only in the Argentina 1978, Bolivia 1992, Ecuador 1982, Switzerland 1971/2010, Uruguay 1987, Mexico 2008, UAE 2010 and Cyprus 2011 tax treaties.

92 The credit method is also used for directors' fees, income of artists and athletes, certain pension incomes and proceeds from the sale of company shares, whose value is more than 50 per cent based on immovable property located in another contracting state; see art. 22(1) No. 3 letters (a)–(e) German model tax treaty.

93 Schnitger, *Internationales Steuerrecht* (2013), p. 626 with further references.

94 See Wassermeyer and Kaeser, *op. cit.*, art. 2 OECD MTC, ann. 56; for a different view see Eglmaier, *Internationales Steuerrecht* (2011), p. 955.

95 For example in art. 23(1) letter (b) United Kingdom tax treaty; art. 23(1) letter (b) tax treaty India; art. 23(1) letter (b) tax treaty Austria; art. 23(3) letter (b) tax treaty USA.

96 Eglmaier, *op. cit.*, p. 951.

Yet this argument is not convincing on even a literal level, since the wording "is subject to the provisions of German tax law" is not equivalent to "provided that a specific set-off provision exists". Rather, such phrases in German tax treaties point out that national set-off terms have to be observed (i.e. method and limits).[97] Additionally, the lack of a set-off regulation in GewStG is not an argument against having a set-off, since the "whether" a set-off exists is regulated by the tax treaties and sections 34c EStG, 26 KStG can be used (analogously) regarding the "how" of set-off.[98] Consequently, the reporters are of the opinion that the arguments in favour of setting off foreign taxes against trade tax are more convincing.

Insofar as a tax treaty requires the crediting of taxes, foreign duties are offset if they are taxes covered by the tax treaty in the sense of article 2 OECD MTC.[99] The basis for setting off a foreign tax is that it has actually been paid. In this context, the term "payment" does not refer to a specific performance procedure. Rather, it is required, and also sufficient, that – economically speaking – a tax has been discharged (*abgeführt*).[100] A definitive determination in another country is not necessary, and the German tax assessment may be amended in accordance with section 175(1) sentence 1 No. 2 AO in case of a subsequent amendment of tax determination in the other country.[101]

2.2.4. Deduction method

Pursuant to section 34c(2) EStG (or in combination with section 26 KStG, as the case may be), a taxpayer may decide to deduct, instead of offset, the foreign tax once income is determined.

Deductions from income offer the possibility of indirectly offsetting foreign taxes against trade taxes, by reducing the basis on which the tax is assessed.[102]

2.3. Non-discrimination

Article 24(1–5) OECD MTC prohibits certain discriminations. According to article 24(6), the non-discrimination rules cover taxes of all types and denominations. Consequently, excise duties and transaction taxes (especially sales tax) as well as inheritance taxes are covered in addition to the taxes listed in article 2 OECD MTC. Social insurance contributions (*Sozialversicherungsbeiträge*), fees (*Gebühren*), dues (*Beiträge*) and special levies (*Sonderabgaben*), however, are not subject to the non-discrimination provision because they are not classified as taxes.[103]

German tax treaties often limit the application of the non-discrimination provision to taxes listed in the provision corresponding to article 2 OECD MTC.[104]

97 See Kessler and Dietrich, *Internationales Steuerrecht* (2011), p. 953; Becker and Loose, *Internationales Steuerrecht* (2012), p. 57.

98 Becker and Loose, *op. cit.*, p. 57; Kessler and Dietrich, *op. cit.*, 108; Wassermeyer, in Wassermeyer, DBA, art. 23A OECD MTC, ann. 104.

99 Wassermeyer in Wassermeyer, DBA, art. 23A OECD MTC, ann. 95.

100 Ismer, *op. cit.*, art. 23A, ann. 131.

101 Wassermeyer in Wassermeyer, DBA, art. 23A OECD MTC, ann. 95.

102 See Kuhn, *op. cit.*, ann. 110.

103 Bruns in Schönfeld and Ditz, DBA, art. 24, ann. 176.

104 Rust in Vogel and Lehner, DBA, art. 24, ann. 185, 187.

For all duties not covered by the provision corresponding to article 24 OECD MTC, taxpayers are protected against discrimination by the rule of equality established in the Constitution (*Grundgesetz*). In matters subject to European Union law, the fundamental freedoms and principles of equality found in the TFEU and in secondary EU legislation[105] offer additional protection against discrimination.

3. Meaning of the term tax when eliminating double non-taxation

3.1. Tax treaty subject-to-tax clauses

3.1.1. Overview of German tax treaties

The exemption method, which is generally the default method in German tax treaties, prevents even theoretical double taxation; that is, the exemption method prevents double tax liability irrespective of whether taxes are actually paid in the other country or not.[106] Therefore German tax treaties often include provisions to prevent this result – which is seen as excessive – and to limit protection to actual double taxation. These provisions are commonly referred to as "reversion clauses" or "subject-to-tax clauses". Subject-to-tax clauses prohibit the application of tax benefits if no (adequate) actual taxation has taken place in the other country. Switch-over clauses prohibit the application of the exemption method and initiate the credit method.[107]

Rules that affect the country of source and rules that affect the country of residence have to be systematically distinguished:

(a) Rules regarding the country of source: in a few German tax treaties, it is a requirement for limitation of German withholding tax that the country of residence does not leave income untaxed based on the principle of territoriality.[108] Some German tax treaties contain subject-to-tax clauses regarding the country of source. According to these, the prerequisite for tax exemption/reduction in the country of source is that corresponding income is actually "subject to tax" in the country of residence.[109]

105 Especially Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States; Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfer of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States; Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

106 Schönfeld and Häck, *op. cit.*, systematics, ann. 12.

107 *Ibid.*, art. 23A/B, ann. 73 *et seq.*, 82 *et seq.*; Wassermeyer in Wassermeyer, DBA, art. 23A OECD MTC, ann. 161 *et seq.*

108 Protocol of the Kenya tax treaty, No. 2; protocol of the Zambia tax treaty, No. 2; see Dürrschmidt in Vogel and Lehner, DBA, introduction to art. 6-22, ann. 17a.

109 Art. 22(1) sentence 2 Portugal tax treaty; art. 15(2) letter (d) Singapore tax treaty; art. 7(2) letter (b), 8(2), 9(1), 12(1), 13(2), 16(1), 19 South Africa tax treaty; see Dürrschmidt, *op. cit.*, ann. 19d *et seq.*

Agreements with countries that only impose tax on foreign income once it is transferred to the country of residence (remittance-base principle) only provide for tax exemption/reduction by the country of source if such income is transferred to the country of residence.[110]

As an example, a German stock corporation (*Aktiengesellschaft*) distributes dividends to a shareholder who is a natural person and resident of Singapore. If the shareholder has the dividend credited to his account in Germany, German withholding tax will be reduced in terms of article 10 of the Germany–Singapore tax treaty, and no tax will be payable in Singapore due to the remittance-base principle. Based on article 22 of the Germany–Singapore tax treaty, Germany therefore has the right to collect capital income withholding tax[111] in full. If the dividend is subsequently transferred to Singapore, German capital gains tax has to be reimbursed.[112]

(b) Regulations regarding the country of residence: subject-to-tax clauses make the exemption method dependent on actual taxation of income in the country of source. Corresponding clauses may be found in either special income articles[113] or method articles.[114] Incorporation in the method article corresponds to the current German model tax treaty, so that future German tax treaties are likely to contain a corresponding clause.[115]

It is very difficult to answer to the question of whether so-called "source clauses" are subject-to-tax clauses or not. Source clauses provide that income is only deemed as originating in the country of source if it is taxed in that country.[116] Current prevailing opinion assumes that such regulations are subject-to-tax clauses, because the requirement for exemption pursuant to article 23A(1) OECD MTC is generation of the income in the other contracting state.[117]

Intervention of a switch-over clause[118] results in the application of the credit method rather than the exemption method. Switch-over clauses usually require the

110 Art. 23 Ghana tax treaty; art. 24 United Kingdom tax treaty; art. 29 Ireland tax treaty; art. 2(2) Israel tax treaty; art. 3(3) Jamaica tax treaty; protocol of the Malaysia tax treaty, No. 3; art. 22 Singapore tax treaty; protocol of the Trinidad and Tobago tax treaty, No. 1 letter (a); see Dürrschmidt *op. cit.*, ann. 18b.

111 Capital income withholding tax (*Kapitalertragsteuer*) is the name for the withholding tax on dividends in Germany. However it is not a stand-alone tax but merely a specific method of collection of income/corporate tax.

112 According to Dörrfuss in Wassermeyer, DBA, art. 22 Singapore tax treaty, ann. 7.

113 For example art. 15(3) sentence 2 and art. 15(4) sentence 2 Switzerland tax treaty.

114 For example art. 22(1) letter (a) Bulgaria tax treaty; art. 23(1) letter (a) United Kingdom tax treaty; art. 22(1) letter (a) Luxembourg tax treaty; art. 22(1) letter (a) Netherlands tax treaty; art. 22(2) letter (a) Spain tax treaty; art. 22(1) letter (a) Hungary tax treaty; art. 23(4) letter (b) alternative 2 USA tax treaty.

115 Art. 22(1) letter (e) German model tax treaty.

116 For example art. 24(3) Denmark tax treaty; protocol to Italy tax treaty, No. 16 letter (d); art. 23(3) New Zealand tax treaty; art. 23(3) Norway tax treaty; art. 23(1) sentence 2 Sweden tax treaty.

117 Federal Fiscal Court, 17 October 2007, I R 96/06, *Bundessteuerblatt* (2008) Part II, p. 953; Federal Ministry of Finance, Decree of 20 June 2013, *Bundessteuerblatt* (2013) Part I, p. 980; for a different view see Dürrschmidt, *op. cit.*, ann. 20f.

118 Only switch-over clauses with the purpose of eliminating non-taxation or taxation at low rates are discussed here. Some German tax treaties also contain switch-over clauses designed to eliminate double taxation. Additionally, some tax treaties offer Germany the possibility to change over to the credit method after consultation and notification.

country of source and the country of residence to classify income as different types of income which would result in non-taxation[119] or taxation at a low rate, and that this conflict cannot be resolved by a mutual agreement procedure. Switch-over clauses are becoming more and more widespread in German tax treaties.[120] By virtue of these, non-taxation or taxation at low rates can be avoided, without simultaneously incurring the risk of double taxation.[121]

Article 23A(4) OECD MTC excludes application of the exemption method as well, provided that the country of source, based on its interpretation of the agreement, assumes it does not have the authority – wrongly, from the point of view of the country of residence – to tax certain income or that it should tax such income at low tax rates only. Since this provision is exclusively based on divergent legal conceptions of the contracting states with regard to the agreement, it is not a subject-to-tax clause.[122] This provision has been included, to a reduced extent, in only a few German tax treaties.[123]

3.1.2. Requirements of subject-to-tax clauses

In this context, the critical question is when taxation levels in the contracting state are high enough to render the subject-to-tax clause ineffective.

The wording of the respective subject-to-tax clauses is an important factor in answering this question. If the clause only requires income in another contracting state to be "subject to taxation" [124] or "taxable",[125] the existence of taxation provisions and lack of personal and objective tax exemptions are sufficient.[126]

According to prevailing opinion, in all other cases – regardless of the wording – income must have actually been taxed.[127] This means that foreign income has to be taken into consideration in determining the assessment basis for a tax subject to the tax treaty in the country of source.[128] The lack of taxation due to the following provisions does not have an adverse effect: personal tax allowances, loss compensation or deduction for other negative income, application of intercompany

119 Whether a clause that opens up the opportunity to switch to the credit method in the case of non-taxation abroad is a switch-over regulation or a subject-to-tax clause, is solely a question of terminology.

120 Art. 23(1) letter (eaa), United Kingdom tax treaty; protocol of India tax treaty, No. 6 letter (caaii); protocol of Italy tax treaty, No. 18 letter (b); art. 22(1) letter (eaa) Luxembourg tax treaty; art. 22(1) letter (eaa) Netherlands tax treaty; art. 28(1) letter (a) Austria tax treaty; art. 23(2) letter (eaa) Russia tax treaty; art. 23(4) letter (b) USA tax treaty.

121 Dürrschmidt, *op. cit.*, ann. 20g.

122 Ismer, *op. cit.*, art. 23A, ann. 250; Wassermeyer in Wassermeyer, DBA, art. 23A OECD MTC, ann. 146.

123 Liechtenstein 2011, Luxembourg 2012, Hungary 2011 tax treaties; see Ismer, *op. cit.*, art. 23A, ann. 252.

124 Art. 18(2) letter (a) United Kingdom tax treaty 1964/1970.

125 Art. 23(1) letter (a) sentence 1 Japan tax treaty.

126 See Schönfeld and Häck, *op. cit.*, art. 23A/B, ann. 76; Federal Fiscal Court, 9 December 2010, I R 49/09, *Bundessteuerblatt* (2011) Part II 2011, p. 482; Cloer and Martin, *Internationales Steuerrecht* (2010), p. 792, 795 *et seq.*

127 Schönfeld and Häck, *op. cit.*, art. 23A/B, ann. 76; Federal Ministry of Finance, Decree of 20 June 2013 (footnote 117).

128 Protocol to the German model tax treaty, ann. 4; Federal Ministry of Finance, Decree of 20 June 2013 (footnote 119), note 2.3; see Schönfeld and Häck, *op. cit.*, ann. 78.

participation exemption as provided by the tax treaty, application of an EU directive or a set-off of foreign taxes. However, personal and objective tax exemptions as well as taxation omitted due to an administrative ordinance or other factual reasons (especially the ignorance of tax authorities regarding income) typically result in non-taxation as required by the subject-to-tax clause.

3.2. Domestic law anti-avoidance provisions

3.2.1. Unilateral subject-to-tax clauses

German law increasingly contains provisions that are designed to prevent double non-taxation or taxation at low rates.

Section 20(2) Foreign Transaction Tax Act (*Aussensteuergesetz* (AStG)) contains a switch-over clause. However, it does not require non-taxation or taxation at low rates; rather, it is triggered when income of a permanent establishment abroad would result in the application of CFC rules in Germany if the permanent establishment were a CFC.

Section 50d(9) EStG also contains two switch-over clauses. According to No. 1, the credit method will be used instead of the exemption method if the other state – erroneously, from the German point of view – implements the tax treaty in a way that results in non-taxation or taxation at a limited rate in the other state. According to No. 2, switch-over will occur if the other state does not assess tax because the taxpayer has no full tax liability due to a lack of residence in that state.

For example, a pilot is a resident of Germany and is employed by an Irish airline company. The pilot is subject to income tax in Ireland, which imposes tax at a low rate. The subject-to-tax clause of section 50d(9) sentence 1 No. 2 EStG does not apply since in Ireland wages are subject to tax, albeit at a low rate, and the regulation requires no taxation for a switch-over.[129]

Finally, section 50d(8) EStG is a subject-to-tax clause with respect to income from employment. It requires the taxpayer to prove that the tax imposed by the other state has been paid or that the other state has waived its right to impose taxes.

3.2.2. Anti-abuse regulations, as linked to non-taxation or taxation at low rates

Both extended limited income tax liability (*erweiterte beschränkte Einkommensteuerpflicht*) under section 2 AStG and CFC rules (*Hinzurechnungsbesteuerung*) under sections 7 *et seq*. AStG require taxation abroad to be at a "low rate".

Section 2(2) AStG states that taxation qualifies as low if the income tax imposed abroad on a taxable income of 77,000 euro for a single person that is a resident of that country is less than two-thirds of what the German income tax would be if the person's state of residence were Germany,[130] holding all other conditions equal (No. 1, the so-called "abstract comparison of tax burden"). Alternatively, the taxation

[129] Federal Fiscal Court, 19 December 2013, I B 109/13, *Sammlung der Entscheidungen des Bundesfinanzhofs* (BFHE) 244, 40.

[130] As far as Germany is concerned in this comparative calculation only income tax in terms of EStG matters, surcharges do not; see Elicker in Blümich, EStG/KStG/GewStG, s. 2 AStG, ann. 21; Federal Fiscal Court, 30 November 1988, I R 84/85, *Bundessteuerblatt* (1989) Part II, p. 365.

in a country qualifies as low if the tax burden of the taxpayer can be reduced significantly compared to the general public in that country due to privileged taxation (No. 2). Both alternatives are based on the income tax "imposed" on foreign territory. All taxes on income that are comparable to German income tax and whose assessment basis is income have to be taken into consideration.[131]

In both cases, the taxpayer has the opportunity to rebut the presumption of a low tax rate by quantitative comparison of tax burdens. Therefore, such rebuttal requires the taxpayer to prove that the total of all taxes to be paid on his income amounts to at least two-thirds of the amount of income tax he would have had to pay in the case of full tax liability in Germany in accordance with section 1(1) EStG. The wording "total of all taxes to be paid on income" includes duties that are taxes under section 3(1) AO[132] and whose assessment basis is income; the term "income" is to be construed in accordance with applicable law in the respective state.[133] Not only must the taxpayer take into account taxes imposed by the country of residence, but *all* taxes on income, including German income tax based on limited tax liability.[134] "Income tax to be paid in the case of full tax liability in accordance with section 1(1) EStG" includes both the German income tax as determined by a hypothetical assessment as well as possible foreign taxes.[135]

With regard to CFC rules, section 8(3) AStG determines the cases a low tax rate is being applied. According to sentence 1, a low tax rate is being applied if the (income) tax burden on passive[136] income amounts to less than 25 per cent. For purposes of this calculation, the assessment basis has to be determined in accordance with German tax law.[137] Duties to be paid have to be classified as taxes on income, that is, taxes whose assessment basis is income/ profit, including supplementary charges, taxes on realised capital gains and trade tax.[138] Section 8(3) sentence 3 AStG states that a tax rate will also be deemed low if taxes of at least 25 per cent are legally owed but not actually collected.

3.2.3. Section 42 AO as general anti-abuse regulation and non-taxation or taxation at low rates (abroad)

The general anti-abuse regulation of section 42 AO also applies in cross-border matters.[139] According to section 42(2) sentence 1 AO, abuse occurs if an inappropriate structure is selected that, compared to the appropriate structure, results in a tax advantage to the taxpayer (or a third party) that is not provided for by the law. In spite of all the difficulties this regulation poses, the determining factor in assessing

131 Könemann in Strunk, Kaminski and Köhler, AStG/DBA, s. 2 AStG, ann. 96; Kraft in Kraft, AStG, s. 2, ann. 52.

132 Bassler in Flick, Wassermeyer, Baumhoff and Schönfeld, *Aussensteuerrecht*, s. 2 AStG, ann. 194.

133 *Ibid*., ann. 196 *et seq*.

134 *Ibid*., ann. 195; Elicker, *op. cit*., ann. 28.

135 Bassler, *op. cit*., ann. 203 *et seq*.; Elicker, *op. cit*., ann. 28.

136 See AEAStG (application decree AStG), *Bundessteuerblatt* (2004) Part I, special issue 1/2004, p. 3, note 8.3.2.1; Vogt in Blümich, EStG/KStG/GewStG, s. 8 AStG, ann. 184.

137 Wassermeyer and Schönfeld, in Flick *et al*., *op. cit*., s. 8 *AStG*, ann. 709 et seq.; Lehfeldt in Strunk, Kaminski and Köhler, AStG/DBA, s. 8, ann. 191.

138 Wassermeyer and Schönfeld, *op. cit*., s. 8 *AStG*, ann. 728; Vogt *op. cit*., ann. 183.

139 Ratschow in Klein, AO, s. 42, ann. 135 *et seq*.

such tax advantage is the reduction of the German tax burden.[140] Therefore, it is irrelevant for classification as abuse in terms of section 42 AO, if and at which rate foreign taxes are paid.

For example,[141] the plaintiff directly owned 25 per cent of shares of a German limited company (*Gesellschaft mit beschränkter Haftung* (GmbH)). Another 55 per cent of shares were owned by a corporation (BV) in the Netherlands. These shares were ascribed to him in accordance with section 42(2) sentence 1 AO, since he held the BV indirectly via a company (B) in the Netherlands Antilles, which he wholly owned. The distribution of profits of the GmbH to the BV pursuant to section 42(2) sentence 1 AO qualified as having been made directly to the plaintiff in economic terms and consequently increased the plaintiff's income tax for the years in question. A set-off of the dividend tax paid by the BV in the Netherlands on the actual distribution to B in accordance with section 34c(1) sentence 1, section 34c(3) and (6) EStG was refused. According to the Fiscal Court, the plaintiff's income is completely domestic and is therefore not subject to section 34c EStG. The case is currently pending at the Federal Fiscal Court.

3.2.4. Application of unilateral anti-abuse regulations in EU and tax treaty matters

Competition between national anti-abuse regulations and tax treaties is a highly topical debate in German tax law. Section 50d(8) and (9) EStG and section 20(2) AStG apply in cases of tax treaties as well. This effect is known as treaty overriding,[142] that is, the regulations limit or abolish the legal consequences resulting from the provisions of a tax treaty.[143]

The constitutionality of treaty overrides is highly contested.[144] In the reporters' opinion, violations of tax treaties, which are treaties under international law, do not constitute violations of constitutional law (rule-of-law principle as in article 20(3) GG). Any other interpretation would contradict the current notion of international law, which, to a large extent, does not have national enforcement mechanisms and, unlike European Union law, has not been granted precedence in the German Constitution (GG).[145] Going forward, the BMF intends to embed subject-to-tax clauses directly into German tax treaties to avoid treaty overriding.[146]

Sections 7 *et seq*. AStG are also treaty overrides because of section 20(1) AStG, which provides that domestic CFC rules will not be affected by tax treaties.

Section 2 AStG does not provide for treaty overriding, so a possible tax treaty would take precedence over section 2 AStG.[147]

140 Schaumburg, *Internationales Steuerrecht*, ann. 16.147; AEAO (application decree AO) 2014, to s. 42, note 2.2; for a different view see Fiscal Court Munich, 25 May 2012, 8 K 1509/10, *Entscheidungen der Finanzgerichte* (2012), p. 1849; in appellate decision s. 42 AO was not discussed, see Federal Fiscal Court, 2 July 2014, I R 57/12, *Sammlung amtlich nicht veröffentlichter Entscheidungen des Bundesfinanzhofs* (2015), p. 11.

141 Fiscal Court Lower Saxony, 21 May 2014, 2 K 216/12, *Deutsche Steuer-Zeitung* (2015), p. 287.

142 See Gosch, *Internationales Steuerrecht* (2008), p. 413, 415 *et seq*.

143 For terminology , see Schönfeld and Häck, *op. cit*., systematics, ann. 148 with further references.

144 The Federal Fiscal Court therefore presented s. 50d(8) EStG to the Federal Constitutional Court.

145 See Rehr, *Steuerberater Woche* (2014), p. 709.

146 Art. 22(1) No. 5 letter (b) German model tax treaty.

147 Elicker, *op. cit*., ann. 9 *et seq*.; Bassler, *op. cit*., s. 2 AStG, ann. 32.

Unless a tax treaty contains final regulations to combat abuse,[148] section 42 AO provides for a different attribution of income based on case law regarding so-called "base companies".

3.3. Administrative assistance

Section 117 AO is the key provision for cross-border administrative assistance. The legal authority for a request for administrative assistance may arise from a treaty under international law, domestically enforceable legal acts of the EU or the Law on EU Administrative Assistance (*EU-Amtshilfegesetz*).[149]

The first example of a treaty under international law is an agreement on the exchange of information regarding fiscal matters. Germany has concluded such agreements with approximately 30 countries.[150] Usually, such an agreement includes income, corporate, trade, capital and inheritance tax and often also sales and insurance tax.[151]

Tax treaties often also include regulations on exchange of information and administrative assistance (see articles 26, 27 OECD MTC). These articles cover all taxes, so that income tax and capital tax, transaction tax and excise tax (especially sales tax) as well as inheritance and gift tax are all included. Older German tax treaties often limit the scope of these articles to taxes that are subject to the treaty.[152] However, articles 25 and 26 German model tax treaty do not provide such limitations, so tax treaty provisions can be expected to deviate in the future.

The EU regulations on cooperation regarding sales tax[153] and harmonised excise taxes[154] have to be cited as examples of important domestically enforceable, legal acts of the EU. Additionally, Germany implemented the EU Recovery Directive (*EU-Beitreibungsrichtlinie*)[155] by introduction of the EU Recovery Act (*EU-Beitreibungsgesetz*),[156] and the Disclosure of Interest Information Regulation (*Zinsrichtlinie*)[157] by introduction of the Disclosure of Interest Information Directive (*Zinsinformationsverordnung*).[158]

148 Ratschow in Klein, AO, s. 42, ann. 143; Drüen in Tipke and Kruse, AO/FGO, s. 42 AO, ann. 102.
149 *Bundesgesetzblatt* (2013) Part I, p. 1809.
150 See *Bundessteuerblatt* (2015) Part I, p. 128.
151 See Engelschalk in Vogel and Lehner, DBA, art. 26, ann. 27b.
152 *Ibid*., ann. 58; art. 27, ann. 11.
153 Council Regulation 904/2010/EU of 7 October 2010 on administrative cooperation and combating fraud in the field of VAT.
154 Council Regulation 389/2012/EU of 2 May 2012 on administrative cooperation in the field of excise duties and repealing Regulation 2073/2004/EC.
155 Council Directive 2010/24/EU of 16 March 2010, concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures.
156 Law on implementation of administrative assistance in the recovery of claims regarding certain taxes, duties and other measures among member states of the European Union, *Bundesgesetzblatt* (2011) Part I, p. 2592.
157 Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments.
158 Ordinance on the implementation of the council directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, *Bundesgesetzblatt* (2004) Part I, p. 128.

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