

# Exemption and Tax Credit in German Tax Treaties – Policy and Reality

**The exemption method used in German tax treaties for major items of income is subject to many restrictions by special clauses in the tax treaties themselves and by treaty-overriding provisions in the domestic tax laws, which are often inconsistent. The author considers that this treaty policy should be revised.**

## 1. Introduction

John F. Avery Jones is, in the area of taxation, one of the most distinguished representatives of a country that is still and always has been regarded as a tax credit country. Germany, on the other hand, is normally perceived as one of the exemption countries (although, as the International Tax Group rightly stated in 1996, “it is strictly incorrect to describe a country as an exemption state”,<sup>1</sup> and, rather, one may speak of a “hybrid tax system”<sup>2</sup>). Accordingly, it might be interesting for John to deal with some related policy issues from a German perspective in this article.

Public discussion and policy decisions on the method of double taxation relief seem to be quite topical. The United Kingdom and Japan recently changed from the traditional credit method to the exemption method for certain types of dividend income. In the United States, discussions have abated,<sup>3</sup> but for many years much attention was given at high political levels to the question of introducing the exemption method for certain types of income.<sup>4</sup> In Canada, consideration has recently been given to broadening the existing exemption system to cover all foreign active business income earned by foreign affiliates.<sup>5</sup> In Germany, on the other hand, taxpayers have suffered from the uncertainty about the future direction of German treaty policy for a number of years as a result of the non-transparent internal discussions held in the German Federal Ministry of Finance and in the parliament’s finance committee.<sup>6</sup> The resulting uncertainty has been ended only recently by the new government, as the coalition agreement of October 2009<sup>7</sup> clearly states that future treaty policy will, in principle, retain the exemption method. However, the discussion may yet resurface because of some unexpected provisions in the new tax treaty between Germany and the United Kingdom, which was signed on 30 March 2010.<sup>8</sup>

In this contribution in honour of John Avery Jones, the discussions are restricted to Germany’s treaty policy regarding the methods used for the avoidance of double taxation of income to situations where Germany is the state of residence. The German treaty provisions are, however, dealt with in the context of some interesting provisions in domestic tax law that are either designed to

avoid international double taxation or safeguard the right to tax irrespective of the application of the tax treaties.<sup>9</sup> This contribution starts with an overview of the application of the tax credit method, followed by a more detailed analysis of some fundamental and certain practical aspects of the exemption method.

For a better understanding of the article, it is useful to note that Germany follows the basic principle of taxing its residents on their worldwide income. For the taxation of income, however, this is only true in respect of the federal taxes (personal income tax and corporation tax). The municipal trade tax on income is levied on those enterprises<sup>10</sup> that carry on business through a permanent establishment (PE) in a German municipality.<sup>11</sup> Foreign profits, i.e. profits derived from other states according to German source rules, are included in the trade tax base if they are attributable to a domestic PE.<sup>12</sup> Profits derived

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1. J.F. Avery Jones et al., “Credit and Exemption under Tax Treaties in Case of Differing Income Characterization”, *European Taxation* 4 (1996), p. 125, also published in *British Tax Review* (1996), p. 223.

2. See US Government Accountability Office, “International Taxation – Study Countries That Exempt Foreign Source Income Face Compliance Risks and Burdens Similar to Those in the United States”, Report to the Committee on Finance, US Senate (“the GAO Report”), September 2009, p. 9.

3. The recent Fiscal Year 2011 Revenue Proposals aim, rather, at protecting the credit method (see, however, the GAO Report, supra note 2).

4. See President’s Advisory Panel on Federal Tax Reform, “Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System”, Report of the President’s Advisory Panel on Federal Tax Reform, November 2005; Joint Committee on Taxation, “Options to Improve Tax Compliance and Reform Tax Expenditures”, JCS-02-05, 27 January 2005; and Office of Tax Policy, US Department of the Treasury, “Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century”, 20 December 2007.

5. Advisory Panel on Canada’s System of International Taxation, Final Report: “Enhancing Canada’s International Tax Advantage”, December 2008 (“Advisory Panel Canada 2008”).

6. B. Welling, “Besorgnisserregende Neuausrichtung in der deutschen DBA-Politik”, *Der Betrieb* 39 (2009), p. 1.

7. *Koalitionsvertrag zwischen CDU, CSU und FDP*, 26 October 2009.

8. At the time of the writing of this article, the Germany–United Kingdom tax treaty (2010) had still to be ratified and enter into force.

9. For a more comprehensive survey of Germany’s tax treaty policy, see J. Lüdicke, *Überlegungen zur deutschen DBA-Politik, Schriften des Instituts für Ausländisches und Internationales Finanz- und Steuerwesen der Universität Hamburg* (Baden-Baden: Nomos, 2008), Vol. 43.

10. Individuals, partnerships, corporations or other bodies corporate, as the case may be.

11. If PEs are located in more than one German municipality, the profit is apportioned by way of a set formula.

12. Examples include interest or royalties paid by foreign residents.

from a PE abroad are not subject to trade tax, irrespective of whether the place of management or of incorporation of the enterprise is located in Germany.

## 2. Tax Credit Method in Domestic Law and German Tax Treaties

### 2.1. Tax credit method in domestic law

Since 1957, the Income Tax Act (*Einkommensteuergesetz*) has provided unilaterally for relief from international double taxation.<sup>13</sup> Foreign income tax levied by a particular state from which, under German rules, the income is derived, is credited against the income tax up to an amount that corresponds to the tax on the income from that state (*Höchstbetrag* or maximum amount, calculated with a per-country limitation).

Technically, the ordinary foreign tax credit requires the taxpayer to be in a taxpaying position in Germany in the given year. If that is not the case, for example, due to overall losses, the ordinary tax credit has no application. From a tax policy perspective, there are, theoretically, three ways of dealing with that situation. First, the law can completely ignore the tax credit shortfall, resulting in double taxation<sup>14</sup> not being eliminated at all. Second, the law can provide for a tax credit carry-forward, which, in a later year, mirrors the decrease in the loss carry-forward caused by the inclusion of the foreign income. Germany has never used this method.<sup>15</sup> Third, the foreign tax can, on application by the taxpayer, be deducted from the foreign income as a business expense and thereby increase a loss carry-forward. The latter is obviously less efficient than an ordinary credit, as it does not reduce the domestic tax by the full amount of foreign tax, but, rather, by an amount that equals the German tax on the foreign tax. Germany chose the third option as early as 1935.<sup>16</sup>

A deduction of foreign tax as a business expense is also allowed where the tax is levied by a state other than the state in which the foreign income is deemed to arise under German source rules.

Both rules, on tax credit and on tax deduction, are indirectly applicable if a tax treaty provides for a foreign tax credit, as the tax treaty does not normally contain a detailed calculation of the amount of the tax credit.

### 2.2. Tax credit method in German tax treaties

#### 2.2.1. Initial comments

Germany used the credit method for the first time in a tax treaty with Canada in 1956 (“computed on the basis of an average rate of taxation”).<sup>17</sup> Since then it has been German policy to apply the credit method, as later implemented by Art. 23A(2) of the OECD Model Tax Convention on Income and on Capital (“the OECD Model”). Initially, however, this only applied to dividend income.<sup>18</sup>

In its more recent tax treaties, Germany has regularly extended the application of the credit method.<sup>19</sup> This is

normally worded as an exception to the exemption method for specifically listed items of income.<sup>20</sup>

The foreign tax is only credited against income or corporation tax, but not against trade tax. The latter omission does not follow from the German tax treaties,<sup>21</sup> which generally cover trade tax as a form of income tax,<sup>22</sup> but from the domestic provisions regarding the calculation of the foreign tax credit, i.e. the Trade Tax Act (*Gewerbsteuergesetz*) simply does not contain any such provision.<sup>23</sup> It follows that the international double taxation is not eliminated if the foreign tax exceeds the corresponding German income or corporation tax on an item of income which is subject to trade tax as well.<sup>24</sup> German treaty policy needs to address this question. After the reduction of the corporation tax rate over the last few decades, an excess foreign tax credit is more likely than ever. In practice, the situation is even worse for the taxpayers concerned, as the source state normally levies its tax on a gross basis, whereas Germany computes the *Höchstbetrag* (maximum amount) of creditable foreign tax on a net basis. Treaty policy may experience some pressure towards more effective foreign tax credit

13. Sec. 34c of the Income Tax Act, which is equally applicable to corporate taxpayers; Sec. 26 (previously, Sec. 19a) of the Corporate Tax Act.

14. The foreign income reduces the tax loss to be carried forward and thereby increases the tax in a subsequent year.

15. The potential conflict of the absence of any tax credit carry-forward with EU law is not discussed here in detail, but reference is made to the ECJ decisions in Case C-138/07, *Cobelfret* (12 February 2009) and Joined Cases C-439/07 and C-499/07, *KBC Bank* (4 June 2009).

16. Sec. 15 of the Income Tax Ordinance (*Einkommensteuer-Durchführungsverordnung*) 1935, currently in force as Sec. 34c(2) of the Income Tax Act.

17. See Art. XVI(2) of the Canada–Germany tax treaty (1956), for dividend and interest income. A detailed rule on the computation of a foreign tax credit was first introduced with effect from 1957 (see 2.1.).

18. Art. 20(2) of the Germany–Luxembourg tax treaty (1958), Art. 19(2) of the Germany–Norway tax treaty (1958), Art. 20(2) of the Germany–Netherlands tax treaty (1959) and Art. 19(2) of the Germany–Sweden tax treaty (1959) deal solely with dividend income; Art. 20(2) of France–Germany tax treaty (1959) deals with dividend income and directors’ fees; and Art. XVIII(3)(b) of the Germany–United Kingdom tax treaty (1966) deals with dividend income and remuneration and pensions paid out of any fund established in the United Kingdom.

19. See the survey by K. Vogel, *Klaus Vogel on Double Taxation Conventions* (3rd ed.) (London: Kluwer Law International, 1997), Art. 23 m.no. 41.

20. Only a few tax treaties concluded between 1971 and 1992 refer to the credit method as the standard rule and explicitly list those items which are to be exempted in Germany; see Vogel supra note 19, Art. 23 m.no. 43a.

21. As an exception, see Art. 24(1)(2) of the Germany–Switzerland tax treaty (1971).

22. See, for example, Arts. I(1)(a) and XVIII(3)(b) of the Germany–United Kingdom tax treaty (1964) and Art. 2(3)(a)(cc) of the Germany–United Kingdom tax treaty (2010).

23. Critical of German practice, see Vogel, supra note 19, Art. 23 m.no. 153a; F. Wassermeyer, in H. Debatin and F. Wassermeyer, *Doppelbesteuerung*, loose-leaf (Munich: C.H. Beck, 2009), OECD-MA Art. 23 m.no. 104; Lüdicke, supra note 9, p. 108 et seq.; and R. Heurung and P. Seidel, “Anrechnung ausländischer Steuern auf Gewerbesteuer und Solidaritätszuschlag”, *Internationale Wirtschaftsbriefe*, Gruppe 5 Fach 3, p. 75 et seq. Interestingly, an early in-depth analysis of the newly introduced domestic provision on foreign tax credit by a government official does not even mention trade tax (see H. Vogel, “Anrechnung und Abzug ausländischer Steuern”, *Außenwirtschaftsdienst des Betriebsberaters* (1958), p. 42 et seq.).

24. Protocol No. 10(e) with reference to Art. 22 of the Australia–Germany tax treaty (1972) states that any such excess foreign tax credit reduces, in a rather complicated pro rata calculation, the income that is subject to trade tax. Similar to the optional deduction of foreign tax in a loss situation, this exceptional rule does not fully offset the tax credit shortfall for all German income taxes.

rules not only from domestic business, but also from Germany's treaty partners, which, in turn, are obliged to give a credit for the German trade tax.

### 2.2.2. Dividends, interest and royalties

Dividends, interest and royalties are taxed in Germany, irrespective of whether or not they can be taxed in the other contracting state. Following Art. 23A(2) of the OECD Model, a foreign tax, if levied in accordance with the tax treaty, may be credited against German income tax.<sup>25</sup>

As an exception it is German treaty policy to exempt intra-group dividends if the participation exceeds a certain threshold (normally 10% in recent tax treaties or 25% in older tax treaties – *internationales Schachtelprivileg* or participation exemption).<sup>26</sup>

### 2.2.3. Other income only subject to limited taxation in source state (directors' fees, artistes' and sportsmen's income)

Para. 31 of the Commentary on Art. 23A of the OECD Model leaves it open to countries which normally provide an exemption in their tax treaties to income other than dividends, interest and royalties, to extend the credit method to other items of income. A good policy reason for such a treatment would be the application of limited taxation in the source state. Examples of such limited taxation can be found for directors' fees (Art. 16) and the income of artistes and sportsmen (Art. 17).<sup>27</sup> As non-residents in the source state, these persons are often taxed, by way of withholding, at rather moderate rates.<sup>28</sup> If they do not have significant business-related expenses, the rate preference is not outweighed by paying tax on a gross basis. For these reasons, it is treaty policy not to exempt directors' fees and the income of artistes and sportsmen, but to give a credit for the respective foreign taxes.<sup>29</sup>

In contrast to the OECD Model, some German tax treaties provide that, in addition to directors' fees and other similar payments made to a member of the board of directors of a company, salaries, wages and other remuneration received by an officer or other official responsible under commercial law for the overall direction of the affairs of a company may be taxed in the state of residence of that company.<sup>30</sup> No legislative reasoning is apparent either for the deviation from the OECD Model or for the consequential inclusion of these salaries in the directors' fees rule on the method for avoidance of double taxation in Germany. The use of the credit method seems to be an accidental and merely technical consequence. As these salaries are, in contrast to directors' fees, normally taxed as income from employment at normal rates, there is no policy reason for them not to be exempted in the same way as other employment income if Germany is the state of residence of the officer.<sup>31</sup>

### 2.2.4. Gains from alienation of shares deriving their value predominantly from immovable property

Under most German tax treaties, the gains of a German resident from the alienation of shares in a company resident in the other contracting state can only be taxed in Germany. In recent tax treaties, however, Germany follows the recommendation of Art. 13(4) of the OECD Model, according to which gains from the alienation of shares deriving their value predominantly (mostly more than 50%) from immovable property situated in the other contracting state may be taxed in that other state. It is German treaty policy to allow for a tax credit for the other state's tax rather than to exempt these gains.<sup>32</sup> At first glance, this may be astonishing, as, in most tax treaties, gains from the alienation of immovable property situated in the other contracting state (Art. 13(1)) are exempt in Germany. One should, however, bear in mind that up to 50% of the underlying value of the shares (and an undefined part of the gain) is derived from assets of the company other than immovable property situated in the other contracting state. It would not be appropriate to exempt automatically that part of the gain, as it would indeed be taxed in Germany (Art. 13(5)) if the company's value did not predominantly consist of immovable property.

### 2.2.5. International hiring-out of labour

As indicated in a reservation to Art. 15 of the OECD Model,<sup>33</sup> it is recent German policy to try to agree<sup>34</sup> on an express clause under which the provisions of Art. 15(2) do not apply to remuneration for employment within the framework of professional hiring-out of labour.<sup>35</sup> It is evident from the discussion in Para. 8 of the Commentary on Art. 15 that such clauses are aimed at safeguarding the taxation of employees in the state in which the

25. Under the new Germany–United Kingdom tax treaty (2010) it is doubtful whether or not this rule applies to interest derived by a resident of Germany and deductible by the debtor of such income. According to the Protocol No. 2, such interest may be taxed by the source state and is, therefore, likely to be exempted by Germany if effectively taxed by the United Kingdom. The same seems to be true for interest and royalties that are effectively taxed by the United Kingdom in triangular cases according to the Protocol No. 3. In contrast, the Germany–United States tax treaty (2006) explicitly provides for a shift to the credit method in triangular cases (Art. 23(3)(b)(cc) and Art. 28(5)).

26. See, for example, Art. XVIII(2)(b) of the Germany–United Kingdom tax treaty (1964/1970); Art. 23(1)(a) of the Germany–United Kingdom tax treaty (2010); and Art. 23(3)(a) of the Germany–United States tax treaty (1989/2006).

27. See, for example, Art. 23(1)(b)(cc) and (dd) of the Germany–United Kingdom tax treaty (2010).

28. The same would be true if vice versa Germany were the source state (see Sec. 50a, Para. 1, Nos. 1 and 4 of the Income Tax Act).

29. The approach in Para. 12 of the Commentary on Art. 17 of the OECD Model to shift to the credit method only in case of double non-taxation seems to be too narrow.

30. See, for example, Art. 16(2) of the Canada–Germany tax treaty (2001). No such rule is included in the new Germany–United Kingdom tax treaty (2010).

31. For more examples and background, see Lüdicke, supra note 9, p. 74.

32. See, for example, Art. 23(1)(b)(bb) of the Germany–United Kingdom tax treaty (2010).

33. Para. 16 of the Commentary on Art. 15 of the OECD Model.

34. Germany obviously did not succeed in doing so in the Germany–United Kingdom tax treaty (2010).

35. For example, Art. 15(3) of the Germany–Korea (Rep.) tax treaty (2000).

employment is exercised. Nevertheless, Germany does not exempt this type of income from employment but rather gives a credit for the source state's tax.

Neither the purpose of these clauses nor the German reservation made in the Commentary can serve as a good policy reason to use the credit method for employees who are hired out whilst applying the exemption method to all other employment income within the meaning of Art. 15 of the OECD Model. If an employee who was hired out is actually taxed in the source state, there is no reason at all to treat him differently from other employees who are equally taxed in the source state according to a provision similar to Art. 15(2). The latter is particularly true since Germany has introduced, by way of treaty override, a unilateral subject-to-tax rule confined to income from employment.<sup>36</sup>

### 2.2.6. Passive business income

Business income derived by a PE in the other contracting state is the most prominent and important example of items of income that Germany exempts under its tax treaties. However, for so-called passive income, one can find an exception to this in many tax treaties, including the new Germany–United Kingdom tax treaty.<sup>37</sup> This exception is dealt with in 3.2.4. in the context of the discussion of the exemption method.

## 3. Exemption Method in Domestic Law and German Tax Treaties

### 3.1. No exemption method in domestic tax law

Neither the Income Tax Act nor the Corporation Tax Act (*Körperschaftsteuergesetz*) provides unilaterally for any exemption of items of income with the explicit purpose of avoiding international double taxation of resident taxpayers.<sup>38</sup> However, international double taxation may incidentally be avoided by unilateral exemption of foreign income in the specific situation of employees. For decades, the German tax administration has exempted income from non-treaty states earned by employees in connection with construction projects or the exploitation of natural resources and the like by way of internal law decrees.<sup>39</sup> The policy reason for that is to encourage employees of the export industry to work abroad by giving them the advantage of low or no taxation in the host state. The exemption may effectively avoid international double taxation, although this is not a prerequisite. On the contrary, taxation in the other state is not a requirement for the exemption. This is perfectly in line with the purpose of the decree, but is inconsistent with the subject-to-tax provision regarding the exemption of employee income by tax treaties.<sup>40</sup>

### 3.2. Exemption method as the standard method in German tax treaties

#### 3.2.1. Some historical observation<sup>41</sup>

When scholars at the end of the 19th century, and later in the League of Nations, started to develop methods for the avoidance of double taxation, they had to combine

the effects of two ways of imposing tax, one being schedular taxes on specific items of income (*impôts réels* or impersonal taxes) and the other being the taxes on a person's overall income (*impôts personnels* or personal taxes).<sup>42</sup> In particular, with regard to the *impôts réels*, there was a clear idea to simply divide the sources of income between the states.<sup>43</sup> As a consequence, the state of residence was not entitled to tax those items of income that were regarded as being more closely connected to the other state,<sup>44</sup> with the exception of dividend income.<sup>45</sup> In contrast to UK and US practice, Germany and some other continental European states followed the method of exempting foreign income from the beginning.<sup>46</sup>

In the tax treaty of 1925 between Germany and Italy, both states found a ground-breaking way to combine personal taxes (*Personalsteuern*) and *impôts réels* (*Sachsteuern*). The allocation of the right to levy personal taxes on items of income mainly followed the allocation of the *impôts réels*.<sup>47</sup> Consequently, double taxation was avoided by exempting items of income from the overall income tax of the state of residence. The "draft of a bilateral convention for the prevention of double taxation" of

36. Sec. 50d(8) Income Tax Act. See also 4.5. The provision is inconsistent with a long-standing unilateral exemption of certain employee income from non-treaty states (see 3.1.).

37. See Art. 23(1)(c) of the Germany–United Kingdom tax treaty (2010).

38. Domestic provisions with regard to members of diplomatic missions or consular posts are not dealt with in this article. The exemption of payments to employees to compensate for a buying rate differential (Sec. 3, No. 64 of the Income Tax Act) emanates from a (questionable) social policy, rather than from the aim of avoiding international double taxation.

39. Decree (*Auslandstätigkeitserlass*) of the Federal Ministry of Finance, 31 October 1983, Federal Tax Gazette, Part I (1983), p. 470; replacing previous decrees of 1960 and 1975 (*Montageerlass*).

40. See 2.2.5.

41. See also Ke Chin Wang, "International double taxation of income: Relief through international agreement 1921-1945", 59 *Harvard Law Review* 1 (1945), p. 73; O. Bühler, *Prinzipien des internationalen Steuerrechts – IStR – Ein systematischer Versuch* (2nd ed.) (Amsterdam: IBFD, 1965), pp. 50 and 193; and K. Vogel, in K. Vogel (ed.), *Freistellung im internationalen Steuerrecht, Münchener Schriften zum Internationalen Steuerrecht* (Munich: C.H. Beck, 1996), Vol. 21, p. 1.

42. See Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations, Document C. 115. M. 55. (1925) II. (F. 212), p. 15. The English expression "impersonal taxes" is not precisely equivalent to the French expression "*impôts réels*", as is rightly stated in the Report.

43. See, from a German perspective, G. Schanz, "Die Doppelbesteuerung und der Völkerbund", 40 *Finanz-Archiv* (1923), p. 363; and H. Dorn, "Die internationale Doppelbesteuerung und ihre Milderung durch die Nachkriegsabkommen Deutschlands", *Steuer und Wirtschaft* (1925), column 1037, at 1049.

44. Namely income from immovable property, from PEs of an undertaking, from public funds, bonds, mortgage bonds, loans and deposits, where the debtor is resident in the other state, and directors' fees, salaries, wages and other remuneration paid by joint-stock companies if the employment is carried out in the other state.

45. Dividends could be taxed by the source state by way of withholding and by the state of residence, leading to double taxation. Bühring pleaded for a change of that policy (in a speech delivered at the German branch of IFA; see H. Bühring, "Grundsätze der deutschen Doppelbesteuerungsabkommen", *Steuer und Wirtschaft* (1954), p. 316). In the Germany–United Kingdom tax treaty (1954) and the Germany–United States tax treaty (1954), Germany exempted such dividends.

46. See, for example, the Germany–Italy tax treaty (1925) or the Finland–Germany tax treaty (1935).

47. See H. Dorn, "Der deutsch-italienische Doppelbesteuerungsvertrag", *Steuer und Wirtschaft* (1926), column 97.

the League of Nations' Committee of Technical Experts<sup>48</sup> reflects the structure of that tax treaty.<sup>49</sup> It was mainly for the sake of simplification that the General Meeting of Government Experts additionally drafted two texts that drew no distinction between impersonal and personal taxes.<sup>50</sup>

After World War II, Germany continued the policy of exempting income that could be taxed by the other state. In its tax treaties of 1954 with the United Kingdom and the United States, for example, Germany used only the exemption method, although the other state used the credit method. These are two early examples where the contracting states actually used different methods to avoid double taxation.<sup>51</sup>

### 3.2.2. Longstanding policy

Although Germany has extended the use of the credit method in its tax treaties from the mid-1950s to date, as shown previously,<sup>52</sup> the standard method for all items of income is the exemption method, unless specifically provided for otherwise. Notably, the exemption method is, in current German treaty practice, applied to:

- income from immovable property situated in the other state, both current and from its alienation (Arts. 6 and 13(1));
- business income attributable to a PE in the other state (Art. 7, but, in many tax treaties, subject to the provision that the PE is “active”),<sup>53</sup>
- income derived from professional services and the like attributable to a fixed base in the other state (Art. 14);
- income from private employment which can be taxed in the other state (Art. 15, in the case of the hiring-out of labour);<sup>54</sup> and
- dividends received by a German company from a company that is a resident of the other state if at least 10% of the capital is held directly (the participation threshold in recent tax treaties, 25% in older tax treaties) (Art. 10(2)(a) and Para. 52 of the Commentary on Art. 23A, but, in many tax treaties, subject to the provision that the subsidiary is “active”).<sup>55</sup>

### 3.2.3. Tax policy reasons

#### 3.2.3.1. General considerations

In economics, there have long been discussions as to whether it is preferable for tax treaties to strive for capital import neutrality (CIN) or capital export neutrality. The fact that the OECD Model offers both the exemption method and the credit method, leads to the clear presumption that it is impossible to derive a generally accepted and overwhelming argument for one or the other method.

The exemption method can obviously lead to unequal taxation of domestic and foreign income. Equal treatment of taxpayers who are in a comparable situation is mandatory under the German constitution. With regard to the ability-to-pay principle, one can debate whether or not two taxpayers who earn the same amount of income

– one taxpayer domestically and the other abroad – are indeed in a comparable situation and should suffer the same final tax burden.<sup>56</sup> If one restricts the consideration to the basic principle of the German income tax system, which seeks to tax the worldwide income, the question must probably be answered in the affirmative. If one extends the consideration, however, to the circumstances of how the taxpayer has earned the income, the different economic and legal conditions in the other state as well as the different competitive environment, including the level of tax charged, one should find sufficient relevant criteria to justify the unequal taxation. Accordingly, it has never been suggested that the application of the exemption method in Germany's tax treaties might be in violation of the German constitution.

#### 3.2.3.2. Negotiating position

The exemption method recognizes the other contracting state's tax system. Tax incentives or the general decision for low tax rates are not overruled. (Germany itself always made use of tax incentives, in particular, to encourage the economy in some middle and eastern parts of the country before and after reunification.) A state using the tax credit method can accomplish a comparable effect by granting a tax sparing credit.<sup>57</sup> In this context, one should note that it is not German policy to conclude tax treaties with tax havens.

In addition to this, one may assume that the exemption of business profits generated in the other contracting state from higher German taxation has frequently contributed to the successful negotiation of a reduction of the other state's withholding tax rates under the tax treaty.<sup>58</sup> The latter is apt to increase German revenue<sup>59</sup> because, as a general rule, those withholding taxes are credited against German tax.

Even if the foreign withholding taxes fail to be credited in full (foreign excess tax credit) and do not burden the budget, a reduction may be of benefit to German industry. Nowadays, this is of particular importance with

48. League of Nations Document, C. 216. M. 85. (1927) II, p. 10 et seq.

49. See H. Dorn, “Doppelbesteuerung und Völkerbund. Die Gutachterentwürfe”, *Steuer und Wirtschaft* (1928), column 49, at column 58.

50. See General Considerations and the Draft Conventions No. 1b and 1c, League of Nations Document, C. 562. M. 178. (1928) II, p. 7.

51. General Considerations and the Draft Conventions No. 1a.

52. See 2.2.

53. See 3.2.4.

54. See 2.2.5.

55. See 3.2.4.

56. Should an overall higher tax result from a higher taxation by the foreign state, this would not conflict with the German constitution as the German state could not in any way be held liable for the measure leading to the unequal treatment.

57. For difficulties and concerns, see Para. 75 et seq. of the Commentary on Art. 23A/B of the OECD Model.

58. Although it is international policy that each contracting state is free to choose the method for the avoidance of double taxation, this does not mean that one state is not interested in the method that the other state applies. Evidence for this can, inter alia, be gained from the fact that some tax treaties provide for a fixed period during which Germany is bound to the method initially elected (see 4.4.).

59. In addition, the fact that exempt foreign losses cannot be deducted from the German tax base (see 3.2.3.3.).

regard to withholding taxes on dividends derived by German corporations, as these dividends are not only regularly exempt by virtue of the tax treaties,<sup>60</sup> but also, without requiring any threshold or activity, under the unilateral dividend exemption.<sup>61</sup>

Germany, as a comparatively high-tax country with few natural resources but an economy that is both strong in and dependent on its export business, has always sought to support its enterprises in doing business abroad. For decades, this policy reason was of overriding importance.<sup>62</sup>

### 3.2.3.3. Issue of tax planning

It is not easy to see what exactly the catalyst was for the discussion of principle that, as noted in 1., has taken place in the German Federal Ministry of Finance over the last few years. In the absence of any published paper, one can only suspect that the considerations were merely influenced by one of the big themes of international tax policy, namely the fear of international tax avoidance by legal tax planning. The creation of untaxed income (nowhere income or white income) was believed to be a planning opportunity that only exists under the exemption method. Although the exemption of an item of income in one state can certainly be used for planning purposes, one should not overestimate this possibility for treaty policy considerations. A significant means of excluding income from a state's taxing rights exists as a result of a foreign subsidiary's corporate veil. This is, however, not a treaty issue.<sup>63</sup> In this respect, even harmful tax competition cannot be countered through electing the credit method instead of the exemption method. In addition to this, another aspect has meanwhile gained more attention in the German discussion, i.e. the credit method also offers extensive planning opportunities, namely with regard to expense allocation and deduction of foreign losses.<sup>64</sup>

The exemption method, on the other hand, as interpreted and applied by German tax practice and case law, prevents a resident taxpayer from deducting expenses connected to, or to set off losses arising from, an exempt foreign PE or immovable property (symmetry thesis).<sup>65</sup> As a consequence, it is not at all evident that a policy switch to using the credit method exclusively for all types of income would, indeed, increase German revenue.

Nevertheless, it is appropriate for the legislator to design domestic tax law as well as tax treaties in a way that ensures that benefits provided for in the law can only be enjoyed by those taxpayers to whom they were intended to apply. Abuse of treaty protection should be prevented. This is, however, equally true for benefits arising from both the exemption and the credit method. However, all respective measures should certainly be appropriate and not go beyond what is necessary to attain their objective. Some respective measures in relation to the exemption method are dealt with below.<sup>66</sup>

### 3.2.3.4. Practicability

One of the most important aspects in favour of the exemption method can be found in its (relative) straightforwardness compared to the credit method. For many exempt items of income, the exact amount as computed under German tax rules and the amount of foreign tax that is finally (and sometimes after disputes) levied are irrelevant for German tax purposes.<sup>67</sup> This certainly does not avoid the need to attribute the income correctly. If income is, however, clearly to be attributed to the foreign state, it does not need to be reconciled to German tax rules (with the unfortunate exception of calculating the overall tax rate if the progression clause is applicable for the taxation of natural persons).<sup>68</sup>

The tax policy choice between exemption and credit method is often discussed as merely relating to business income from foreign PEs and possibly real estate. One should, however, not underestimate the interrelationship between business profits derived in an own PE and profits derived in a foreign subsidiary.<sup>69</sup> In multinational corporations, both types of doing business abroad are, to a certain extent, interchangeable. Consequently, one may question the wisdom of a tax system which exempts foreign dividends received by a company, but taxes income derived by a foreign PE by granting a foreign tax credit.<sup>70</sup>

60. *Schachtelprivileg*, see 2.2.2.

61. Sec. 8b(1) of the Corporation Tax Act, introduced in 2001.

62. See W Ritter, speech given in London to the British branch of IFA on 12 December 1990, published as "Die deutsche Vertragspolitik zur Vermeidung der Doppelbesteuerung", *Betriebs-Berater* 6 (1991), p. 353.

63. The attribution of foreign income irrespective of a dividend payment under CFC rules is not dealt with in this article.

64. Interestingly, the US Joint Committee on Taxation (JCT) estimated an increase of US taxes by USD 54.8 billion from 2005 to 2014 as a result of the introduction of a dividend exemption system for foreign business income. See JCT, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05, 27 January 2005. See also P. Merrill et al., "Restructuring foreign-source-income taxation: U.S. territorial tax proposals and the international experience", 111 *Tax Notes* (15 May 2006), p. 799.

65. See BFH (Federal Tax Court) of 28 June 2006, I R 84/04, *Federal Tax Gazette* Part II 2006, p. 861.

66. See 3.2.4. and 4.

67. Similarly, see the GAO Report, *supra* note 2, p. 25.

68. The precise computation of the tax-exempt income for the determination of the German tax rate of taxable income is less important where a high average rate of tax applies anyway, and the exempt income is quite low. In practice, the discretion exercised by the tax authorities reflects this. During the public hearing before the ECJ in Case C-414/06, *Lidl Belgium* (15 May 2008), it was accepted by counsel for the local tax office that such discretion had been exercised.

69. See Lüdicke, *supra* note 9, p. 64 and W. Schön, "International Tax Coordination for a Second-Best World (Part II)", *World Tax Journal* 1 (2010), p. 69.

70. See similarly, but stressing practical issues, HM Treasury, "Taxation of companies' foreign profits: discussion document", June 2007, Para. 3.9, "Although there are clear links between the taxation of foreign dividends and of the overseas branches of UK companies, considering foreign PEs now would raise a large number of additional issues, which would divert focus from the present discussion: so depending on the outcome, the Government considers it would be more appropriate to return to this question at a later date". See also Advisory Panel Canada 2008, *supra* note 5, Paras. 4.74 and 4.76, "Conceptually, there is no reason to tax foreign-source active business income earned through a foreign branch of a Canadian company differently than such income earned through a foreign affiliate. However, exempting a foreign branch's active business income from Canadian tax would require complicated rules ..." and "The Panel believes that treating the foreign active business income of foreign branches and foreign affiliates more consistently is a desirable goal, but the practical difficulties involved currently outweigh the benefit of uniform treatment".

Particularly in a high-tax country, such a system would inevitably offer certain incentives towards setting up a foreign subsidiary even for rather short-term activities in a foreign state. The other policy option is not to exempt foreign dividends received by companies, but to grant an indirect tax credit for the underlying foreign corporate tax. Until 2000, Germany operated such an indirect corporate tax credit system unilaterally if dividends from a foreign participation of at least 10% were not exempt under the participation exemption of a tax treaty. The indirect corporation tax credit for taxes paid by foreign first and second-tier subsidiaries<sup>71</sup> was extremely laborious and required careful planning to avoid credit shortfalls that resulted in international double taxation not being relieved. Most importantly, the inclusion of only two levels of subsidiaries turned out to be too restrictive. If the German legislator were to decide to switch again to an indirect tax credit for foreign dividends, modern group structures with sometimes dozens of layers of subsidiaries would inevitably require a much more generous approach. The practical difficulties, both for enterprises and for the tax administration, are obvious.

All in all, German treaty policy would be well advised to adhere to the exemption method. The ability to carry out business cross-border, without being subject to undue constraints resulting from either material taxation or related administrative burdens should nowadays be regarded as even more important than ever.

### 3.2.4. Activity clauses for business income and the participation exemption

It has been German treaty policy for a long time to make the exemption of specific types of foreign income dependent on it arising exclusively or almost exclusively from so-called active or productive occupation. Activity clauses are mainly provided for in tax treaties with non-industrial states.<sup>72</sup> They normally relate to business income from PEs abroad (including income from the alienation of movable and immovable property attributable to such PEs) and to inter-company dividends on substantial shareholdings (participation exemption).<sup>73</sup>

It is suggested that the activity clauses that were developed in the 1960s and 1970s be revisited in today's German tax environment. Activity clauses are not specifically recommended or included in the OECD Commentaries. The clauses in the German tax treaties differ significantly from each other. In addition, they often differ from the so-called activity catalogue of the German controlled foreign corporation (CFC) rules.<sup>74</sup> Application and interpretation are, therefore, difficult.

In addition to this, the legal consequence of the activity clauses in German tax treaties differs from the one applicable to the CFC rules if an item of income of a low-taxed subsidiary or PE does not meet the activity criteria. In the latter case, the taxation of the low-taxed passive income is restricted to this very income, whereas under tax treaties any item of passive income that is not immaterial (compared to the total income of that subsidiary or

PE) "infects" all other income of that subsidiary or PE as passive, too.<sup>75</sup> It is difficult to find a convincing argument for this rigid effect of the activity clauses in the German tax treaties.

The activity clauses in many German tax treaties, as in the new tax treaty with the United Kingdom,<sup>76</sup> make reference to current income and income from the alienation of immovable property used by the PE and situated in the other contracting state. As Germany exempts all income from immovable property in the other state which is not attributable to a PE in that state, there is no good policy reason at all why such income is subject to the activity clause if the immovable property is part of the PE of a business in the other state.<sup>77</sup>

Most importantly, from a tax policy point of view, the traditional activity clauses heavily interfere with the domestic system of taxing foreign dividends, compared to the system of taxing income from foreign PEs. The taxation of business income consists of federal income tax or corporation tax on the worldwide income and of local trade tax on income of domestic PEs. From 2001, the economic double taxation of dividends has been mitigated by preferential tax rates (income tax) or exemption (corporate tax).<sup>78</sup> In this legal framework, the usual German activity clauses have the following consequences:

- A dividend of a foreign company that forms part of domestic business income is, under domestic income and/or corporation tax law, taxed at preferential rates or is exempt. It is not relevant whether or not the dividend is passive under a tax treaty.<sup>79</sup> If, indeed, the distributing foreign company derives a more than immaterial part of its income from passive activities, the dividend is, however, subject to trade tax. Neither the domestic participation exemption in the Trade Tax Act<sup>80</sup> nor the participation

71. Sec. 26(5) of the Corporation Tax Act (before abolition of the domestic imputation system in 2001).

72. In the absence of any official communication within Germany, it is not yet clear why Germany included an activity clause in the new Germany–United Kingdom tax treaty (2010).

73. *Schachtelprivileg*; see 2.2.2. For more details, see Vogel, supra note 19, Art. 23 m.nos. 43, 88.

74. Sec. 8 Foreign Tax Act (*Außensteuergesetz*).

75. See, for example, Art. 23(1)(c) of the Germany–United Kingdom tax treaty (2010): "... derived exclusively or almost exclusively from [good] activities ...".

76. See Art. 23(1)(c) of the Germany–United Kingdom tax treaty (2010) and also, for example, Art. 23(2)(c) of the Canada–Germany tax treaty (2001).

77. It seems reasonable to suppose that the respective language of the activity clauses relating to immovable property does not pursue any policy objective but is rather the result of (unreflective) duplication of a similar provision contained in the Germany–Switzerland tax treaty (1971) and the Germany–Kuwait tax treaty (1999). In these tax treaties, Germany applies the credit method to income from immovable property, the provision in question having the reasonable consequence of extending the exemption method used for active PE income to income from immovable property if it belongs to an active PE. See Lüdicke, supra note 9, p. 81.

78. See 3.2.3.2.

79. Yet, the passive income may, indeed, be attributed to the German shareholder under the CFC rules, which are not to be dealt with here.

80. Sec. 9, No. 7 of the Trade Tax Act for shareholdings which exceed a threshold of 15%. Taxation of such dividends is, however, excluded if the shareholding meets the requirements of the EU Parent-Subsidiary Directive (90/435/EEC).

exemption of an applicable tax treaty prevents this taxation, as both contain an activity clause according to which the whole dividend is deemed to be passive if it is infected by more than an immaterial amount of passive income.

- Foreign PE income of an individual or company is subject to full income and/or corporation tax at standard rates if the income is passive according to the activity clause of the applicable tax treaty, i.e. if the item of income is indeed passive or if it is active by its nature, but infected by other passive items of income of that PE. The income is, however, not subject to trade tax, as trade tax is based on the principle of territoriality; a tax treaty, with or without activity clause, has no impact on the trade tax position.

These results are apparently inconsistent. The German treaty policy regarding activity clauses needs to be reconciled with the general tax policy as applied since the tax reform in 2001. As there are good policy reasons for both domestic rules – the preferential treatment of dividends (the avoidance of economic double taxation) and the exemption from trade tax of income derived through in foreign PEs (the fundamental principle of territoriality) – it follows that the German taxation should not be altered in this respect. On this basis, it is suggested that the policy change should distinguish between income and/or corporation tax and trade tax.

Nowadays, the treaty exemption for foreign PE income is normally not a particularly attractive rule for corporations, as such income would only be subject to corporation tax of some 15.8%<sup>81</sup> anyway, but not to trade tax. Individual taxpayers, on the other hand, might well be inclined to derive passive income through a foreign exempt PE, as their domestic income tax rate may be as high as 45%. Potential tax savings may still be significant, although Germany unilaterally denies the exemption by way of treaty override<sup>82</sup> insofar as the PE income meets the criteria of the CFC rules (income is of a passive nature and not subject to a foreign tax of at least 25%). Therefore, it seems to be a reasonable option to agree on an activity clause in a tax treaty as well if the German legislator, despite the tax level in the other state not falling short of the threshold in the German CFC rules, still feels uncomfortable about tax planning possibilities.<sup>83</sup> However, such a switch should be restricted to items of income of the PE that are passive by nature and not infected active PE income.

On the other hand, there is no obvious policy reason for the inclusion of dividends from foreign participations in the trade tax base, whilst passive income derived from an own foreign PE is not subject to that tax. Furthermore, tax policy should take into account that the participation exemption for trade tax of dividends received from domestic companies includes all distributed profits, even if they were derived from a passive foreign PE and, therefore, not yet subject to trade tax. Consequently, it should not matter if the distributing company is a foreign one. Accordingly, both the activity clauses in the German tax treaties insofar as they relate to the treatment of div-

idends for trade tax purposes, and the activity clause in the Trade Tax Act as it pertains to foreign dividends<sup>84</sup> should be abolished.<sup>85</sup>

After all, the use of activity clauses needs to be overhauled. Germany should continue to refrain from including them in tax treaties with other developed countries with acceptable levels of taxation and with other Member States of the European Union. Even though the Court of Justice of the European Union (ECJ)<sup>86</sup> seems to accept the use of different methods for the avoidance of double taxation, the application of an activity clause only towards selected Member States conflicts with both the idea of a level playing field within the European Union and the desirable absence of investment control. Even if a political agreement on a minimum corporate tax rate within the European Union cannot realistically be expected in the foreseeable future, any disparate treatment of investments in other Member States on the grounds of a discretionary grouping for treaty negotiations or of a specific tax rate (presently, 25%) as in the German CFC rules seems in the end to be arbitrary.

## 4. Treaty Policy Concerning Restrictions of the Exemption Method

### 4.1. Introductory remarks

When Germany, in the early post-World War I tax treaties, started to exempt income, this was entirely unconditional. No measure in Germany's tax treaties or in its domestic law prevented a resulting double non-taxation. Currently, German treaty policy is more concerned about undesired double non-taxation or the rate of taxation being too low.<sup>87</sup> As a consequence, Germany reverts to several different provisions that, to some extent, pursue the same objective.

81. Comprising 15% corporation tax and 5.5% solidarity surcharge.

82. Sec. 20(2) Foreign Tax Act. See also 4.5.

83. One may wonder whether or not this is the case with regard to the United Kingdom.

84. For a careful criticism with regard to the different treatment of profits that were originally derived through a foreign PE, see D. Gosch, in Blümich, *Einkommensteuergesetz – Körperschaftsteuergesetz – Gewerbesteuerengesetz*, loose-leaf (Munich: C.H. Beck, 2009), GewStG, Sec. 9, m.no. 288, and G. Güroff, in P. Glanegger and G. Güroff, *Gewerbesteuerengesetz* (7th ed.) (Munich: C.H. Beck, 2009), Sec. 9, No. 7, m.no. 1.

85. In extreme cases, these clauses can even lead to economic double taxation with domestic profits derived by a foreign company being subject to trade tax: if that company has more than immaterial passive income its income derived through its domestic PE is subject to trade tax at the company's level and on distribution at the shareholder level too.

86. The ECJ in Case C-298/05, *Columbus Container Services* (6 December 2007). For a different view, see M. Lang, "Tax Treaty Policy", in K. Andersson et al. (eds.), *National Tax Policy in Europe* (Berlin: Springer, 2007), p. 204.

87. A usual wording in recent tax treaties is: "... the relevant income or capital would remain untaxed or be taxed too low", for example, in the Germany-Kuwait tax treaty (1999). There is an ongoing debate in German professional literature when too-low taxation has to be assumed in an international tax environment. The language used in the new Germany-United Kingdom tax treaty (2010) seems, in this respect, to be more appropriate: "... would remain untaxed or be taxed lower than without this conflict".

## 4.2. Restrictive interpretation of obligation to exempt items of income and Art. 23A(4) of the OECD Model

### 4.2.1. New OECD approach after the Partnership Report

Following the ground-breaking analyses and comprehensive elaboration by the International Tax Group, in particular by John F. Avery Jones and David Ward,<sup>88</sup> the OECD has, in its Partnership Report<sup>89</sup> and in the 2000 update of the Commentary,<sup>90</sup> changed the interpretation of Arts. 23A(1) and 23B(1) of the OECD Model. The OECD nowadays distinguishes between the various reasons behind the source state not taxing or taxing an item of income that, according to the interpretation and application of the tax treaty by the state of residence, can or cannot be taxed by the source state.<sup>91</sup>

Where, due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income or capital, provisions of the Convention that are different from those that the State of residence would have applied to the same item of income or capital, the income is still being taxed in accordance with the provisions of the Convention, as interpreted and applied by the State of source. In such a case, therefore, the two Articles require that relief from double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.<sup>92</sup>

A conflict of qualification where the divergence is based on different provisions of domestic law, as described in the preceding quotation from the OECD Commentary (case group 1), must be distinguished from conflicts resulting from different interpretation of facts (case group 2) or different interpretation of the provisions of the tax treaty (case group 3).<sup>93</sup>

These statements in the Commentary relate to the state of residence's obligation to eliminate double taxation in cases of divergence, i.e. where the state of residence would not have to give relief under Art. 23A or 23B of the OECD Model if the source state's qualification of income were consistent with that of the state of residence.

Situations of possible double non-taxation are dealt with in Para. 32.6 of the Commentary on Art. 23A/B of the OECD Model:

Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to have the right to tax that income if it had been in the position of the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.<sup>94</sup>

The wording of this paragraph is seemingly less clear as to the differences dealt with in Paras. 32.3 and 32.5 of the Commentary on Art. 23A/B of the OECD Model. Nevertheless, the denial of the obligation on the state of residence to exempt an item of income because the source state applies the tax treaty differently is meant to be restricted to cases where the source state's interpretation

of the tax treaty is different from the residence state's because of differences in domestic law (case group 1). Evidence for that can be gained from the respective section in the Partnership Report<sup>95</sup> and in particular from the reasoning for the newly suggested Art. 23A(4).<sup>96</sup>

### 4.2.2. Treaty policy: switchover clauses

The German policy with regard to these new OECD developments is somewhat complicated. As a Member country of the OECD, Germany has, in principle, agreed to the new interpretation and no observation has been added by Germany to the Commentary on Art. 23A/B of the OECD Model. The recently inserted Art. 23A(4) has, however, not yet been used in any German tax treaty. On the contrary, Germany continuously uses a switchover clause which the German treaty practice developed in the 1980s and amended in the late 1990s. Initially, the clause required Germany or gave Germany the right to use the credit method to avoid either double taxation or double non-taxation, respectively.<sup>97</sup> Later on, the clause was restricted to eliminating double non-taxation.<sup>98</sup> For the latter, Germany switches from the exemption method to the credit method if "in the Contracting States items of income or capital are placed under differing provisions of this Agreement or attributed to different persons" and if this conflict cannot be settled by a mutual agreement procedure and "if as a result of this difference in placement or attribution the relevant income or capital would remain untaxed or be taxed lower than without this conflict."<sup>99</sup>

88. J.F. Avery Jones et al., "Interpretation of Tax Treaties," *Bulletin for International Fiscal Documentation* 2 (1986), p. 77 and "The Interpretation of tax treaties with particular reference to article 3(2) of the OECD Model," *British Tax Review* (1984), p. 50; J.-M. Dery and D. Ward, "Interpretation of double taxation conventions – National Report Canada," *Cahiers de Droit Fiscal International*, Vol. LXXVIIIa (Deventer: Kluwer, 1993); and Avery Jones et al., supra note 1.

89. OECD, "The Application of the OECD Model Tax Convention to Partnerships," *Issues in International Taxation*, No. 6 (Paris, 1999) ("the Partnership Report").

90. Para. 32.1 et seq. of the Commentary on Art. 23A/B of the OECD Model.

91. Concurring, see K. Vogel, in K. Vogel and M. Lehner, *Doppelbesteuerungsabkommen* (5th ed.) (Munich: C.H. Beck, 2008), Einl. m.no. 157 et seq., Art. 3 m.no. 96 et seq. and Art. 23 m.no. 37 and K. Vogel, "Conflicts of Qualification: The Discussion is not Finished," *Bulletin for International Fiscal Documentation* 2 (2003), p. 41, but dissenting, see, for example, M. Lang, *The Application of the OECD Model Tax Convention to Partnerships. Schriftenreihe zum Internationalen Steuerrecht* (Vienna: Linde, 2000), Vol. 11, p. 20.

92. Para. 32.3, second and third sentences of the Commentary on Art. 23A/B of the OECD Model.

93. Para. 32.5, fourth sentence of the Commentary on Art. 23A/B of the OECD Model.

94. Para. 32.6, second and third sentences of the Commentary on Art. 23A/B of the OECD Model, including the amendments made by the 2008 update.

95. See Para. 109 in connection with Para. 112 et seq. of the Partnership Report, supra note 89.

96. Para. 56.3 of the Commentary on Art. 23A/B of the OECD Model.

97. The relevant clause was dealt with by Avery Jones, supra note 1. For other examples, see Canada–Germany tax treaty (1981), Protocol No. 13; Germany–Italy tax treaty (1989), Protocol No. 18 lit. a and b; and Germany–Lithuania tax treaty (1997), Protocol No. 7 lit. b aa i and ii. For more background information, see T. Menck, "Der Qualifikationskonflikt im neuen deutsch-kanadischen Doppelbesteuerungsabkommen," *Intertax* (1982), p. 417.

98. See, for example, Art. 45(1)(a) of the Denmark–Germany tax treaty (1995) and Art. 23(2)(e)(aa) of the Germany–Russia tax treaty (1996), as early examples of the current treaty practice.

99. See as an example for the currently used language Art. 24(1)(e)(aa) of the Germany–Singapore tax treaty (2004).

This is still German treaty policy, most recently seen in the tax treaty with the United Kingdom.<sup>100</sup> There are four remarkable aspects. First, the denial of the exemption is dependent on an unsuccessful prior mutual agreement procedure. The corresponding domestic treaty override provision is considered later.<sup>101</sup> Second, it is not clear either from the wording of or from the German technical explanations to these tax treaties<sup>102</sup> whether or not the switchover clause is aimed at covering all three groups of cases of double non-taxation, irrespective of why they arise. A recent circular on the application of tax treaties to partnerships<sup>103</sup> suggests that the switchover clauses are applied in all cases of double non-taxation. As Germany has agreed to the new OECD interpretation, one might, however, assume that explicit switchover clauses are not needed for conflicts due to divergent domestic law (case group 1).<sup>104</sup> Third, as recent German tax treaties do not stipulate any explicit rule on how to avoid double taxation resulting in any of the three groups of cases, one may wonder whether Germany is prepared to apply the new OECD approach.<sup>105</sup> According to the recent circular,<sup>106</sup> Germany, indeed, gives relief from double taxation by either exempting the respective item of income or by crediting the foreign tax, as the case may be. However, it is a requirement that a prior mutual agreement procedure has been unsuccessful.

Fourth, there is an overlap if a tax treaty contains both<sup>107</sup> a switchover clause regarding the avoidance of double non-taxation and a subject-to-tax clause.<sup>108</sup> If the latter works properly, it is hard to see how an item of income could “remain untaxed”<sup>109</sup> in both states. The question arises whether or not Germany is obliged to carry out a mutual agreement procedure before switching to the credit method, i.e. not exempting the income, in cases of conflicting application of the tax treaty if as a result of the conflict such income is not effectively taxed in the other state as required by the subject-to-tax clause.<sup>110</sup>

#### 4.3. Subject-to-tax clauses in German tax treaties

Occasionally, German tax treaties exempt an item of income only under the proviso that it has been subject to taxation<sup>111</sup> or has been taxed effectively<sup>112</sup> in the other state (subject-to-tax clause). As in the vast majority of German tax treaties<sup>113</sup> one cannot find subject-to-tax clauses and they should not be regarded as a common element of German treaty policy, it is difficult to see which deliberations lead to them being included in the respective tax treaties. Possibly, one can assume that the treaty negotiators were otherwise not satisfied about the effective avoidance of double non-taxation. Interestingly, the new tax treaty with the United Kingdom provides such a subject-to-tax clause, but for unknown reasons.<sup>114</sup>

It is unclear as to whether or not the subject-to-tax clauses relate to the total amount of all items in one category of income derived by a certain activity in the other state or rather to each single item of income.<sup>115</sup> In the new tax treaty with the United Kingdom, the German expression “*Einkünfte*” seems to refer to the former,

whereas the English expression “any item of income” may refer to the latter.<sup>116</sup>

Subject-to-tax clauses interfere with the generally accepted principle that the state of residence must exempt income whether or not the right to tax is in effect exercised by the other state.<sup>117</sup> They contravene the idea of CIN, which governs the exemption method. Good treaty policy should, therefore, refrain from stipulating such clauses if there is no particular reason which can be found in the other state’s tax system.<sup>118</sup>

#### 4.4. General switchover to credit method on diplomatic notification

In 1991, the Finance Committee of the *Bundesrat*<sup>119</sup> required the German treaty policy to remain flexible as to the method used for the avoidance of double taxation. Due to the nature of tax treaties, however, a general policy change translates into effective law only over decades, as respective provisions need to be agreed on with all treaty partners. Therefore, Germany has in almost all tax treaties<sup>120</sup> since then reserved its right to switch for some or all types of income from the exemption method to the credit method with effect for the future.<sup>121</sup> The intended switch needs prior consultation with and notification to the other state through diplomatic channels.<sup>122</sup>

100. See Art. 23(1)(e)(aa) of the Germany–United Kingdom tax treaty (2010).  
101. See 4.5.

102. See, for example, *Denkschrift* (official memorandum) to the German tax treaty with Singapore, *Bundestags-Drucksache* 16/1619, at 32, or with the United Kingdom (2010), *Bundesrats-Drucksache* 326/10, at 38.

103. Federal Ministry of Finance, 16 April 2010, Federal Tax Gazette, Part I (2010), p. 354, Para. 4.1.3.2.

104. This view is shared by a former German treaty negotiator who was also involved in the preparatory work for the OECD Partnership Report (see H. Krabbe, in *Debatin and Wassermeyer*, supra note 23, Denmark Art. 45 m. no. 3, 7 and similarly Italy, Art. 24 m.no. 66).

105. See Paras. 32.3 and 32.4 of the Commentary on Art. 23A/B of the OECD Model.

106. See Federal Ministry of Finance, 16 April 2010, Federal Tax Gazette, Part I (2010), p. 354, Para. 4.1.3.3.1.

107. See, for example, Art. 23(1)(a) and (e)(aa) of the Germany–United Kingdom tax treaty (2010).

108. For details, see 4.3.

109. For the usual language in German tax treaties, see 4.2.2. at note 99.

110. *Denkschrift*, supra note 102, at 38, is silent on this question.

111. See, for example, Art. 23(3) of the Germany–New Zealand tax treaty (1978).

112. See, for example, Germany–Italy tax treaty (1989), Protocol No. 16 lit. d: “*effektiv*” and “*effettivamente*”.

113. Including recently the Germany–Singapore tax treaty (2004), the Algeria–Germany tax treaty (2007) and the Germany–Mexico tax treaty (2008).

114. See Art. 23(1)(a) of the Germany–United Kingdom tax treaty (2010). *Denkschrift*, supra note 102, at 38, does not give any reasoning.

115. If the latter were correct, the income derived, for example, from a PE in the other state had to be split up in individual items (like specific proceeds from sales, services, investment grants, etc.).

116. Art. 23(1)(a) of the Germany–United Kingdom tax treaty (2010). *Denkschrift*, supra note 102, at 38, is again silent.

117. See Para. 34 of the Commentary on Art. 23A/B of the OECD Model.

118. The German technical explanations to the few relevant tax treaties do not mention any particular policy reasons.

119. The Second Chamber of the German parliament.

120. For more details, see Lüdicke, supra note 9, p. 100.

121. See, for example, Art. 23(1)(e)(bb) of the Germany–United Kingdom tax treaty (2010).

122. In the Germany–Singapore tax treaty (2004), Germany is bound to the exemption method for an initial period of five years after the entry into force of the tax treaty (see Germany–Singapore tax treaty (2004), Protocol No. 4).

#### 4.5. Domestic treaty override provisions regarding treaty exemption

In addition to the long-standing use of switchover clauses in its tax treaties, Germany has over time introduced some unilateral provisions according to which, irrespective of treaty provisions, foreign income is not exempt from taxation.

In this regard, in order to prevent circumvention of the CFC rules with regard to foreign corporations, Germany does not exempt – irrespective of a treaty obligation – income attributable to a PE in the other state if that income would be subject to the CFC rules had the PE been a corporation resident in that state.<sup>123</sup>

In addition, in 2004, Germany, by way of a treaty override, introduced a provision according to which income from employment is only treaty exempt insofar as the taxpayer gives evidence that the other state either has actually collected the tax due or has waived its right to tax the income.<sup>124</sup>

Another specific unilateral subject-to-tax clause was introduced in 2007 by way of treaty override. The treaty exemption is denied if the income is not taxed by the other state due to provisions in its domestic tax law prohibiting that state to tax that income for the sole reason that the taxpayer is not liable to unlimited taxation because of his domicile or any other similar criterion.<sup>125</sup>

Most importantly, a further treaty override provision was introduced simultaneously (with retroactive effect), according to which a treaty exemption is not granted if the other state applies the tax treaty in a way which results in that income not being taxed or taxed only at a reduced rate.<sup>126</sup> This provision is heavily debated for a number of reasons, which are not all dealt with in this article. For international readers, the most interesting questions are how one can reconcile the rule with the new OECD interpretation of Art. 23A/B of the OECD Model and with the usual German switchover clauses. The legislative materials, indeed, refer to Para. 32.6 of the Commentary on Art. 23A/B, but are silent regarding switchover clauses.<sup>127</sup>

However, one can doubt as to whether or not the new German provision is a fair implementation of the general understanding within the OECD. The cited paragraph of the Commentary ties in with the previous paragraphs, and the distinction between the three groups of cases of different application of a tax treaty<sup>128</sup> is relevant in cases of double non-taxation as well. It is simply a misinterpretation of Para. 32.6 of the Commentary on Art. 23A/B of the OECD Model when the legislative materials suggest that all three situations can be treated equally under the existing tax treaties and lead to the state of residence not being obliged to grant the exemption as stipulated in the tax treaty.<sup>129</sup> If the latter were a correct interpretation, the new Art. 23A(4) of the OECD Model would be redundant. Consequently, the intended retroactive effect of the new domestic provision can, in cases of differing interpretation of the facts or of the pro-

visions of the tax treaty, not be based on the new OECD approach.

With regard to switchover clauses in German tax treaties, a conflict exists insofar as they allow for a denial of the exemption only after an unsuccessful prior mutual agreement procedure. The domestic rule overrides this requirement and the agreed procedure seems to be of no meaning any longer. Whilst this is an unsatisfactory situation with regard to tax treaties which were concluded before 2007, German treaty policy needs to resolve this conflict for new tax treaties. It is neither acceptable for taxpayers nor for other states that a switchover clause that requires a mutual agreement procedure is concluded,<sup>130</sup> although domestic law overrides this prerequisite ab initio.

Overall, it seems that the German treaty policy should consolidate the various measures against undesired results of the exemption method and head for a better and fairer balance.

## 5. Conclusions

The exemption method has certainly benefited German taxpayers in general and the export industry in particular. There is no evidence that the advantages of the exemption method for taxpayers as well as for the tax administration, notably the reduced degree of complexity of both the rules and the practical application, were overcompensated by dramatic and steady shortfalls in revenue as a result of abusive tax planning. The diverse measures, aimed at restricting the use of the exemption method, that were developed at different times and under different conditions, can and should be revisited.

Even if the economic crisis and the resulting budget deficits of many states may suggest that competition for revenue will become stronger, good tax and treaty policy should not consider short-term revenue increases, but, rather, long-term economic and fiscal conditions for business. In a country like Germany, the adequate and lasting application of the exemption method can contribute to this.

123. Sec. 20(2) Foreign Tax Act.

124. Sec. 50d(8) Income Tax Act. For the inconsistency with other German rules regarding unilateral exemptions of income from employment, see 3.1.

125. Sec. 50d(9), No. 2 Income Tax Act.

126. Sec. 50d(9), No. 1 Income Tax Act.

127. See *Bundestags-Drucksache* 16/2712, at 61.

128. See 4.2.1.

129. Vogel, in Vogel and Lehner, *supra* note 91, Einl. m.no. 181, is of the opinion that, therefore, only cases of conflicts by reason of differing domestic law (case group 1) are subject to the provision. The recent circular (Federal Ministry of Finance, 16 April 2010, Federal Tax Gazette, Part I (2010)) shows, however, the opposite intention of the tax administration. See also R. Resch, "The New German Unilateral Switch-Over and Subject-to-Tax Rule", *European Taxation* 10 (2007), p. 482.

130. The recent circular on the application of tax treaties on partnerships (see Federal Ministry of Finance, 16 April 2010, Federal Tax Gazette, Part I (2010), p. 354, Para. 4.1.3.2.) is not entirely clear in this respect. With regard to Art. 23(1)(e)(aa) of the Germany–United Kingdom tax treaty (2010), it is clarified that the treaty rule has precedence (see *Denkschrift*, *supra* note 102, at 38).