tax notes international

Volume 60, Number 1 ■ October 4, 2010

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

German Treaty Overrides: Contractual Duties Meet Fiscal Interests

by Wolfgang Kessler and Rolf Eicke

Reprinted from *Tax Notes Int'l*, October 4, 2010, p. 41

taxanalysts® The experts' experts.℠

FEATURED PERSPECTIVES

German Treaty Overrides: Contractual Duties Meet Fiscal Interests

by Wolfgang Kessler and Rolf Eicke

Wolfgang Kessler is the director of the tax department of the business and economics faculty at the University of Freiburg and a partner with Ernst & Young in Freiburg, Germany. Rolf Eicke is an attorney-at-law with Ernst & Young in Freiburg. The views expressed here are entirely their own. E-mail: Wolfgang.Kessler@tax.uni-freiburg.de and Info@Dr-Eicke.de

The Latin principle *pacta sunt servanda* (''agreements must be kept'') serves as a cornerstone of social interaction, peace, and justice. If a breach of contract did not have some sort of ramification, the motivation to stick to the stipulations of the treaty would decrease greatly, the ultimate consequence being that the party bearing the detrimental effects of the contractual relationship is the one not breaching the contract. That's why a breach of contract without a sound justification is punished in all areas of law — well, except for international tax law.

In fact, overriding a treaty is a classic example in the international tax law arena. According to the 1989 OECD Report on Treaty Overrides, the term ''treaty override'' primarily includes ''the enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations.'' Reuven S. Avi-Yonah calls overriding a treaty a ''serious threat to the bilateral tax treaty network.''[1]

In most countries, treaties have a status superior to that of ordinary domestic law (for example, Belgium, France, Greece, Luxembourg, the Netherlands, Russia, and Spain).

Yet in some countries treaties can be changed unilaterally by subsequent domestic legislation (for example, Australia, Austria, Denmark, Finland, Germany, Sweden, the U.K., and the U.S.). Two problems arise from this situation: the clear infringement on international law, and even worse, the helplessness of treaty partners and taxpayers because they only have weak or no legal remedies to restore justice.

Termination Not Best Practice

Of course, the violation of international law embodied in the Vienna Convention on the Law of Treaties (VCLT) grants the other party the right to terminate the treaty. However, as a 1989 OECD report[2] states, termination could do even more harm economically and endanger the possibility of finding an acceptable solution in the future. After evaluating the options, the treaty partner whose laws are being breached finds itself in a dilemma. Easier remedies would be a mutual agreement procedure or treaty renegotiations for an adequate and quick revision of the treaties.

Treaty overriding clearly violates international law. However, since courts are likely to follow domestic law even if it violates international law, both taxpayers and the other treaty partner have little practical recourse in the case of a treaty override beyond terminating the treaty, which is an extreme and rarely taken step.

---

[1] ''Tax Treaty Overrides: A Qualified Defence of U.S. Practice,'' in: *Tax Treaties and Domestic Law*, G. Maisto (ed.), pp. 65-80, EC and International Tax Law Series, Vol. 2, Amsterdam: IBFD Publications, 2006.

[2] ''OECD Committee on Fiscal Affairs Report on Tax Treaty Overrides,'' *Tax Notes Int'l*, Jan. 1, 1990, p. 25, *90 TNI 7-13*.

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Therefore, the OECD in its 1989 report urged member countries to refrain from treaty overrides.

This article argues that the seriousness of the treaty override problem has been exaggerated. In practice, most countries, including the U.S. (which was clearly the target of the OECD report), rarely override treaties, and when they do, in most cases the override can be justified as consistent with the underlying purposes of the relevant treaty. Moreover, treaty overrides can sometimes be an important tool in combating tax treaty abuse. Thus, if used correctly, treaty overrides can be a helpful feature of the international tax regime, albeit one that should be used sparingly and with caution.

An income tax treaty is a contract governed by international public law and under the rules of the VCLT. Germany follows a dualistic approach, meaning that rules of international public law must be transformed by an act of parliament (article 59(2) of the German Basic Law or Grundgesetz) to be become national law and thus subject to judicial review.

The Acceptors . . .

The legal status after the transformation is crucial in deciding whether a treaty override is in conformity with the constitution.

The vast majority of authorities and the Supreme Tax Court have used the following arguments.

German law does not give income tax treaties precedence over other national provisions. While article 25 of the Basic Law provides for ''friendliness towards international public law'' (Völkerrechtsfreundlichkeit des Grundgesetzes) and section 2 of the General Tax Code (Abgabenordnung) provides that agreements of international public law prevail over national law, supporters of treaty overrides do not find these arguments convincing. Supporters of treaty overrides maintain that section 2 of the General Tax Code cannot constitute a hierarchy of laws as it is merely a basic law itself. Instead, the legislature is free to give precedence over an income tax treaty provision through the general principle that special legislation overrides general legislation, as long as the wording recognizes the treaty override. Thus, there is no infringement on the constitution; however, undoubtedly there is an infringement on international public law.

. . . and the Lonely Callers

For a long time, Klaus Vogel was the only one criticizing treaty overrides. Even though his arguments were sound and convincing, he turned out to be like a lonely caller in the desert. Vogel's point was that treaties override the domestic tax law that is effective at the time of their implementation. Moreover, the supplementary rule that later general legislation does not overrule earlier special legislation does not automatically affect existing treaties. Only when general law is expressly or implicitly intended to repeal the special law does a general law overrule special legislation.

Recently, the chair of the international tax law senate of the German Supreme Tax Court (Bundesfinanzhof), Dietmar Gosch, doubted that treaty overrides are in conformity with the constitution. Gosch classified treaty overrides into three groups:

- historic treaty overrides that have always existed;
- treaty overrides to safeguard tax revenue; and
- treaty overrides to prevent double nontaxation.

Gosch refers to a recent judgment of the German Constitutional Court (Bundesverfassungsgericht), the *Görgülü* decision of October 14, 2004, in which the court found an obligation of all public institutions to comply with international public law, which in *Görgülü* was the European Convention for the Protection of Human Rights and Fundamental Freedoms. The court derived the duty from the rule-of-law principle (section 20(3) of the Basic Law). Gosch thought that the legislature's duty was to comply with international public law when transforming income tax treaties into national law and to justify any infringements.

In case of a paradigm shift to Vogel's and Gosch's point of view in the future, all German income tax treaties must be revised. We believe that it would be worth the effort. We understand the need for flexibility for the legislature; however, buying flexibility for the price of a treaty override and infringement on international public law is the wrong way. Trust and reliability are valuable not only among human beings but also among countries. Any tolerated infringement poisons the relationship.

Any treaty override that does not explicitly target artificial arrangements is and will always be an illegal breach of a treaty. ◆

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.