Chapter 16

Subject-to-Tax Clauses in Tax Treaties – A German Experience

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16.1. Introduction

Traditionally, the exemption method, as stipulated in article 23A of the OECD Model, prevents not only "effective" double taxation but also so-called virtual double taxation.[1] The state of residence exempts income or capital which, in accordance with the provisions of the tax treaty, may be taxed in the source state. Leaving aside the issue of differing interpretations of the treaty as a consequence of differences in domestic law[2] or of other reasons,[3] the exemption is given irrespective of whether or not the income or capital gives rise to any tax liability in the source state under its domestic law.[4]

Double non-taxation is increasingly considered objectionable by tax administrations and the public. The OECD Model, however, does not include a general subject-to-tax clause, nor does it propose such a clause as a general matter of treaty policy. Nonetheless, the commentary suggests that negotiating states may "make an exception to the absolute obligation on the State of residence to give exemption", for example "where no tax on specific items of income or capital is provided under the domestic laws of the State of source, or tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired".[5]

1. OECD, Commentary on Articles 23A and 23B of the OECD Model Tax Convention on Income and on Capital (15 July 2014), para. 34; J.M. Mössner, *Germany*, in *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law* p. 99 (P. Essers, G. Bont & E. Kemmeren eds., Kluwer 1999).
2. *See* the analysis of conflicts of qualification for the purposes of applying article 23 of the OECD Model in OECD, The Application of the OECD Model Tax Convention to Partnerships (1999, below: "Partnership Report"), para. 94 et seq.; OECD, Commentary on Articles 23A and 23B (15 July 2014), para. 32.1 et seqq. (suggested in OECD, Partnership Report, p. 57 et seq.).
3. *See* article 23A(4) OECD Model.
4. *See* A. Rust, *Art. 23 OECD Model Convention*, in *Klaus Vogel on Double Taxation Conventions*, para. 20 (E. Reimer & A. Rust eds., Kluwer 2015).
5. OECD, Commentary on Articles 23A and 23B (15 July 2014), para. 35.

Under a subject-to-tax clause, the tax treatment of income or capital in the state of residence depends on its tax treatment in the other contracting state. The OECD, in its 2015 Report on BEPS Action 2, rightly stated that the proposed "'linking rules' make the application of domestic law more complicated".[6] These difficulties seem to be acceptable to the OECD. Without giving any further explanation to the difficulties or their potential removal, the report simply refers to the OECD Hybrid Mismatch Report of 2012, which "noted that such rules are not a novelty as, in principle, foreign tax credit rules, subject to tax clauses, and controlled foreign company rules (CFC) often do exactly that".[7] The Hybrid Mismatch Report, unfortunately, is no more specific either.[8]

The purpose of this contribution is to outline problems inherent to tax treaty subject-to-tax clauses. Germany, as a so-called exemption state,[9] did not always negotiate subject-to-tax clauses in its tax treaties. Until recently, such clauses could be found only in some of them, with a significant increase during the last few years. There was seemingly no strict policy as to when or with which "category" of contracting states a subject-to-tax clause was included in Germany's treaties.[10] After the publication of the German "Basis for negotiation for agreements for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital"[11] (*Verhandlungsgrundlage für Doppelbesteuerungsabkommen*, German Negotiation Basis (GNB))[12] in April 2013, one should expect Germany to insist in future treaty negotiations on including a subject-to-tax clause in all tax treaties.

The subject-to-tax clause in article 22(1) of the GNB[13] reads, in the German government's official English version, as follows:

6. OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report, para. 2.
7. Id.
8. OECD, Hybrid Mismatch Arrangements, 2012, para. 34.
9. *See* J. Lüdicke, *Exemption and Tax Credit in German Tax Treaties: Policy and Reality*, in *Tax Polymath: A life in international taxation*, at pp. 269, 277 et seq. (P. Baker & C. Bobbett eds., IBFD 2010); J. Lüdicke, *Exemption and Tax Credit in German Tax Treaties – Policy and Reality*, 64 Bull. Intl. Taxn. 12, secs. 1., 3.2. et seqq. (2010).
10. *See* Lüdicke, id. (IBFD 2010), at p. 292; Lüdicke, id. (Bull. 2010), at sec. 4.3.
11. *See* https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Steuern/Internationales_Steuerrecht/Allgemeine_Informationen/2013-08-22- Verhandlungsgrundlage-DBA-englisch.pdf?__blob=publicationFile&v=8 (update as of 22 Aug. 2013).
12. For a general overview of the GNB, *see* M. Lipp, *Germany's Tax Treaty Negotiation Policy*, 54 Eur. Taxn. 7 (2014), p. 313 et seq.
13. Article 22 of the GNB is the equivalent to article 23A/B of the OECD Model.

> 5. Notwithstanding subparagraph 1), double taxation shall be eliminated by a tax credit as provided for in subparagraph 3), if
>
> a) …
>
> b) *[jurisdiction]* may, under the provisions of the Agreement, tax items of income or capital, or elements thereof, but does not actually do so;[14]
>
> c) ….

The protocol specifies in No. 4:

> It is understood that items of income or capital, or elements thereof, are taxed when they are included in the taxable base by reference to which the tax is computed. They are not actually taxed if they are either not taxable or exempt from tax.[15]

Furthermore, in June 2013, the German Federal Ministry of Finance issued a circular[16] dealing with, inter alia, its interpretation of subject-to-tax clauses in existing treaties (the circular). The wording of all existing treaties[17] is notably different from the wording in the GNB, in that the existing treaties refer to "*Einkünfte*" ("income" or "items of income" respectively), but not to "*Einkunftsteile*" ("elements thereof").

The subject-to-tax clause as drafted in the GNB and the German tax administration's interpretation of such clauses have raised a lot of concern among German tax practitioners and academia.[18] The debate is not only of interest

14. The German version reads: "b) *[anderer Vertragsstaat] Einkünfte oder Vermögen oder Teile davon nach dem Abkommen besteuern kann, tatsächlich aber nicht besteuert;*".
15. The German version reads: "*Einkünfte oder Vermögen oder Teile davon werden 'tatsächlich' besteuert, wenn sie in die Bemessungsgrundlage einbezogen werden, auf deren Grundlage die Steuer berechnet wird. Sie werden nicht 'tatsächlich' besteuert, wenn sie nicht steuerpflichtig sind oder von der Besteuerung ausgenommen werden*".
16. *See* DE: *Bundesministerium der Finanzen* (below referred to as "BMF"), BStBl. (German Federal Tax Gazette) I 2013, p. 980.
17. The only exception is article 23(3)(b) Germany-Liechtenstein (2011), which refers to "*Einkünfte oder Einkunftsteile*" ("items of income or elements thereof"). Article 22(2)(e)(i) Germany-Australia and Article 22(2)(e)(ii) Germany-Japan (neither yet in force as of the time of writing) also refer to income or elements thereof.
18. D. Endres/C. Freiling, *Deutsche Verhandlungsgrundlage für DBA: Musterfälle zur Auslegung (Teil 2)*, 16 Praxis Internationale Steuerberatung 3, p. 74, at p. 76 et seq. (2014); R. Gebhardt/M. Reppel, *Die neuen Subject-to-tax-Klauseln in deutschen DBA – Praxisfälle und Zweifelsfragen im Kontext des BMF-Schreibens vom 20.6.2013*, 22 Internationales Steuerrecht 20, p. 760 et seq. (2013); A. Meretzki, *Die (Nicht-) Besteuerung von Einkünften als zentrales Tatbestandsmerkmal abkommensrechtlicher Subject-to-tax Klauseln*, 3 Internationale Steuer-Rundschau 2, p. 42 et seq. (2014); J. Schönfeld, *Welche praktischen Probleme löst das BMF-Schreiben zu Subject-to-Tax-Klauseln und welche nicht? – dargestellt anhand von Fallbeispielen*, 22 Internationales Steuerrecht 20, p. 757 et seq. (2013). As regards the GNB's subject-to-tax clause, *see also* G. Roderburg/O.

in Germany, as it highlights the inherent difficulties of rules under which the taxation in one state is made dependent on details of the taxation under the uncoordinated and often quite different tax rules of another state.

The theoretical and practical difficulties when applying subject-to-tax clauses mainly relate to three areas, namely: (i) what is income (or capital) or an item of income (or capital) or elements thereof (*see* section 16.2.)? (ii) what does "taxation" or "actual (effective) taxation" in the source state mean if there are timing or other mismatches in the tax base, losses and the like (*see* section 16.3.)? and (iii) how can the taxpayer provide for evidence of the source state's taxation (*see* section 16.4.)? Although these questions relate to subject-to-tax clauses, they are, mutatis mutandis, relevant whenever the tax laws of a state take into account the tax treatment of items of income or of expenses in another state's tax system.

16.2. Items of income or capital or elements thereof

16.2.1. No definition of the term "income" in tax treaties, the GNB or the circular

Neither the GNB nor the Federal Finance Ministry's circular define the term "income" as used in tax treaties' and the GNB's subject-to-tax clauses. Article 22 of the GNB, the article dealing with the avoidance of double taxation in the state of residence generally, and its subject-to-tax clause in particular, refers to income and its treatment in the other contracting state. Therefore, one may draw the conclusion that income within the meaning of the subject-to-tax clause must be interpreted primarily in a treaty sense, as opposed to the sense given to it by domestic law. The OECD Model's English version refers to "income" in its article 23A(1), (3) and (4); the original French version in the same provisions refers to "*revenus*". Article 23A(2) refers to "items of income" and "*des éléments de revenu*", respectively. The GNB's subject-to-tax clause, dealing both with "items of income … or elements thereof" ("*Einkünfte … oder Teile davon*"),

Rode, *Die Missbrauchsabwehrregelungen in der deutschen Verhandlungsgrundlage für Doppelbesteuerungsabkommen und der Sonderfall Liechtenstein*, 2 Internationale Steuer-Rundschau 5, p. 149, at p. 153 (2013). As regards the BMF's circular of 20 June 2013, *see also* C. Kahlenberg/R. Mair, *BMF: Praktische Auswirkungen abkommensrechtlicher Subject-to-tax-Klauseln*, 16 Praxis Internationale Steuerberatung 1, p. 10 et seq. (2014); R. Kammeter, *Die Rückfallklausel – von der virtuellen zur tatsächlichen Doppelbesteuerung*, 60 IWB Internationale Wirtschafts-Briefe 20, p. 720 et seq. (2013); J. Lüdicke, *Subject-to-tax-Klauseln nach den DBA: Bemerkungen zum BMF-Schreiben vom 20.6.2013*, 22 Internationales Steuerrecht 19, p. 721 et seq. (2013).

apparently refines this approach but contains no definition; neither does the protocol attached to the GNB provide for a definition.

The treaty terms "income" and "*Einkünfte*" may correspond to gross or net amounts, of which only the latter is a balance between receipts and expenses. For example, dividends and interest dealt with in articles 10(3) and 11(3) of the OECD Model normally are perceived as income in the form of gross amounts. By contrast, article 7(1) of the GNB and the OECD Model refer to "profits of an enterprise", which is an aggregation of single receipts and expenses,[19] and consequently may be considered a net amount. It is therefore likely that the term "items of income" in article 23A(2)(1) of the OECD Model also refers to gross amounts, while "income" in article 23A(1) of the OECD Model refers to a net amount when the underlying distributive provision is article 7 of the OECD Model.

16.2.2. Income from different sources

The article for the avoidance of double taxation specifically applies to the different categories of income as dealt with in the distributive provisions but does not overall provide exemption or credit for all income categories; rather, the article is applied with reference to each distributive provision.

A taxpayer may derive income of different categories (e.g. from immovable property and from employment) from the same contracting state but may also derive income of the same (treaty) category from different sources in the same contracting state (e.g. from two separate sites in different cities).

The terms "income" and "items of income" do not refer to any aggregate amounts derived from different sources. Against this background, tax treaties and their subject-to-tax clauses should be considered with respect to each category and source, meaning that the treaty is not applied to an overall balance of income of the same category from different sources in the same contracting state.[20]

19. E. Reimer, *Art. 7 OECD Model Convention*, in Reimer & Rust, *supra* n. 4, at paras. 16, 171. For the German perspective, *see* X. Ditz, *Art. 7 OECD Model Convention*, in *Doppelbesteuerungsabkommen*, m.no. 60 (J. Schönfeld & X. Ditz eds., Otto Schmidt 2013).
20. Lüdicke, *supra* n. 18, at p. 724; Meretzki, *supra* n. 18, at p. 45; A. Meretzki in F. Wassermeyer et al., *Personengesellschaften im Internationalen Steuerrecht*, m.no. 15.24 et seq. (2nd edn. 2015).

16.2.3. Fragmentation ("atomization") of income from a single source

16.2.3.1. The new approach by the German tax administration

However, the approach taken by the Federal Ministry of Finance is not restricted to the above-mentioned, source-concentrated analysis of income. In two examples given in its circular,[21] it singles out interest attributable to a German taxpayer's PE in the United States, as well as royalties derived from third states by a partnership of a German company in the United States, and advocates their taxation in Germany in case they remain untaxed in the United States. These examples illustrate that the ministry does not deal with them as inseparable components of the "profits of an enterprise" derived from the PE as their source but isolates single gross receipts for the purposes of the subject-to-tax clause.

This fragmentation of net amounts into taxed and untaxed gross receipts (and expenses) has been termed "atomization" ("*Atomisierung*") in German professional tax literature.[22] Moreover, it seems that this approach is not restricted to business profits but equally applies to single components of income from, for example, employment.[23]

With regard to existing tax treaties which only refer to "income" or "items of income" but not to "elements thereof", as the GNB in article 22(1)(5)(b) does, this approach is remarkable. The latter addition in the GNB allows drawing the conclusion that such "elements" of items of income do not as such equal income or items of income and that a subject-to-tax clause dealing only with income cannot simply be applied to single elements of items of income. In the past, it was unclear how to interpret the term "items

21. *See* BMF, *supra* n. 16, at para. 2.3.
22. Lüdicke, *supra* n. 18, at p. 724 et seq.; J. Schönfeld, X. Ditz & N. Häck, *Art. 22 DE-VG*, in Schönfeld & Ditz, *supra* n. 19, m.no. 169.
23. Para. 5 of the circular not only suspends the relevant part of the main circular dealing with PEs (*Betriebsstätten-Verwaltungsgrundsätze*) (Administrative principles as regards permanent establishments, 24 Dec. 1999), BStBl. (German Federal Tax Gazette) I 1999, p. 1076, at para. 1.2.6., but also of the circular dealing with the treatment of income from employment by tax treaties (*Steuerliche Behandlung des Arbeitslohns nach den Doppelbesteuerungsabkommen*) (Fiscal treatment of income from employment for the purposes of tax treaties, 14 Sept. 2006), BStBl. I 2006, p. 532, at para. 9.1.). The new circular dealing with the treatment of income from employment by tax treaties (12 Nov. 2014, BStBl. I 2014, p. 1467, at para. 9, m.no. 309) specifically refers to the circular on subject-to-tax clauses.

of income" in the English versions of German tax treaties,[24] i.e. whether it refers to net income or, more specifically, to single gross components of net income. The new reference to "elements thereof" in article 22(1)(5)(b) of the GNB therefore reveals that the concept of "items of income" must refer to net amounts but not to its single gross components.

Article 7, and consequently the article on the avoidance of double taxation in the state of residence (article 23), in this respect deal with profits of an enterprise, i.e. income as a net amount, whereas the latter article's subject-to-tax clause, as interpreted by the tax administration, specifically refers to single business transactions. Even considering article 3(2) of the OECD Model for the purposes of interpreting the term "income", German domestic law would not change this result but would eventually provide for a net amount.

Generally, gross amounts such as dividends, interest and royalties are dealt with separately in articles 10, 11, 12 and, as the case may be, 21 (in particular, as regards third states) of the OECD Model and are not qualified as profits of an enterprise according to a tax treaty's provision equivalent to article 7(4).[25] But if such dividends, interest, royalties or other income are functionally attributable to a PE in the other contracting state (unanimously by both contracting states),[26] they are expected to be treated as components of the enterprise's net profits and are not dealt with independently. Neither articles 10, 11, 12 or 21 nor article 7 of the OECD Model provide for a different understanding. Considering that other gross amounts which are inseparable from the business profits (e.g. an investment allowance) can also form part of a PE's net result, there appears to be no particular reason why another conclusion should be reached when dealing with, for example, interest.

24. Lüdicke (IBFD 2010), *supra* n. 9, sec. 4.3., at p. 293. *See also* Rust, *supra* n. 4, at para. 35.

25. *See* article 7(7) of the OECD Model until the implementation of the AOA in the 2010 revision.

26. In case the source state does not functionally attribute the income in question to the PE and thus applies one of articles 10, 11 and 12 or article 21 of the OECD Model to the income in question, while Germany applies article 7 of the OECD Model, a conflict of qualification occurs. This is the situation specifically targeted by Germany's switch-over clauses in tax treaties and domestic law (article 22(1)(5)(a) of the GNB and, for example, section 50d(9) and (10) of the German Income Tax Act).

16.2.3.2. The "atomization" of income in German case law and former administrative practice

The approach of considering gross amounts separately for the purposes of a treaty's subject-to-tax clause is not in line with the German Federal Fiscal Court's case law and the tax administration's former understanding. In its judgment of 27 August 1997, the German Federal Fiscal Court held with respect to article 23(3) of the former Canada-Germany tax treaty of 1981 that the agreed exemption of business profits must also be provided in situations where parts of the net amount are not taxed in Canada.[27] In particular, it would not be possible "to dissect and take to pieces"[28] the Canadian PE's profits. The same approach is taken by the Federal Fiscal Court with regard to the question of whether income is taxed by a treaty state when applying the domestic switch-over clause in section 50d(9) of the German Income Tax Act.[29] In a similar vein, the former circular of 14 September 2006 dealing with the treatment of income from employment by tax treaties applied this jurisprudence and considered it immaterial that single components of an employee's income were not taxed in the other contracting state if the income in general was taxed there.[30] However, this position was repealed by the circular of 20 June 2013[31] and was not readopted in the new circular of 12 November 2014 on the treatment of income from employment by tax treaties.[32]

In the author's opinion, in the absence of any specific reference to gross earnings, the general interpretation of existing treaties' subject-to-tax clauses[33] provided by the circular in its examples 1 and 2 lacks a legal basis. In a recently published draft of a tax bill, the following amendment is proposed: a subject-to-tax clause or a switch-over clause of a tax treaty which refers to "income" will be applied to "income and elements thereof". If this proposal is enacted (amendments during the legislative process are still possible), the "atomization" approach of the tax administration will become

27. DE: BFH (German Federal Fiscal Court), 27 Aug. 1997, I R 127/95.
28. Id., at II.2. (*zu sezieren und in seine Einzelteile zu zerlegen*).
29. DE: BFH, 19 Dec. 2013, I B 109/13; 20 May 2015, I R 68/14; 20 May 2015, I R 69/14; 21 Jan. 2016, I R 49/14.
30. *See supra* n. 23, at para. 9.1.
31. *See* DE: BMF, *supra* n. 16, at para. 5.
32. *See supra* n. 23. In this 2014 circular on the treatment of income from employment by tax treaties reference is only made to the circular of 20 June 2013 (para. 9, m.no. 309).
33. For a differently drafted subject-to-tax clause, *see* article 23(3)(b) of the Germany-Liechtenstein tax treaty of 17 Nov. 2011. As mentioned in n. 17, that provision expressly refers to "*Einkünfte oder Einkunftsteile*".

law – but only in the form of a treaty override for the majority of tax treaties. The draft bill intends that the new rule should be applicable from 2017.

16.2.3.3. The "atomization" of income from a policy perspective

The "atomization" of income is questionable not only with respect to tax treaties already in force but also with respect to future tax treaties modelled on the GNB and thus containing an express reference to elements of items of income. The consideration of the exemption method with respect to each single gross earning would not only defeat the exemption method's straightforward application, and hence one of its main advantages,[34] but also disregards tax policy decisions of the other contracting state.

This may be demonstrated by the taxation of employees. It is common practice in many states to exempt, for various reasons, specific parts of an employee's overall income, e.g. overtime or Sunday premiums and per diems, and relocation or other (flat) allowances. However, the types and maximum amounts of such tax-free payments differ significantly. It would not meet the policy objective to avoid international double taxation of employees' income by the exemption method if the exemption is denied for a specific premium or allowance only because it was paid free of tax under the source state's sovereign tax system. It should be borne in mind that other payments which the state of residence treats as tax exempt under its domestic rules may well be taxable in the source state.

Similar considerations apply to other situations, as in one of the examples given in the circular.[35] In this example, certain interest that is not taxable in the other contracting state (objective tax exemption) and that is part of a PE's profits would be taxable in Germany as the state of residence applying a tax treaty's subject-to-tax clause. This approach is not limited to financial institutions (as is the case in the example) but also applies to businesses of other sectors, e.g. car manufacturers investing cash reserves in fiscally privileged (state or municipal) bonds. Curiously, it does not matter whether a lower interest rate was stipulated due to the tax exemption granted by the other contracting state's domestic tax law for interest flowing from such public bonds for the purposes of the application of the subject-to-tax clause; the result would economically have been the same if a higher interest rate had been agreed and no tax exemption had been granted, but for

34. Rust, *supra* n. 4, at para. 36. For the exemption method's practical advantages, *see* Lüdicke (IBFD 2010), *supra* n. 9, sec. 3.2.3.4., at p. 282 et seq.
35. *See* DE: BMF, *supra* n. 16, at para. 2.3(b), *Beispiel* 1.

the residence state's tax purposes the subject-to-tax clause would not have applied.

Finally, looking at every single gross earning which is part of net income as dealt with in the tax treaty would lead to inconsistencies compared to the credit method as it is applied in Germany (and other states). If the nominal tax rate is higher in the source state than it is in the residence state,[36] single gross receipts that are not taxed in the source state normally do not result in higher taxes in the residence state, because the foreign tax credit limitation generally is calculated for all income from each state (per country limitation) or at least from one source in the other state. By contrast, denying the exemption to each such gross receipt due to a tax treaty's subject-to-tax clause would necessarily result in more tax in the state of residence, because the receipt that remained untaxed in the state of source is taxed in the state of residence.

The effect may be illustrated with the following example:

The taxpayer derives income of 100,000 in the source state. The source state treats 10,000 thereof as a tax-free amount (e.g. a tax-free investment grant or allowance) and taxes 90,000. Under the assumption of a (flat) tax rate of 20%, the tax amounts to 18,000. The state of residence, under its tax laws, regards the full amount of 100,000 as taxable. Under the assumption of a (flat) tax rate of 15% (which reflects the current German corporate income tax rate), the tax would amount to 15,000. If double taxation was avoided by the credit method using a per country limitation like in Germany (or a per source limitation), no tax would be due in the state of residence. Hence, the overall tax burden would amount to 18,000. If double taxation, however, would be avoided by the exemption method using a subject-to-tax clause on a gross receipt per "elements" basis, the state of residence would exempt the (taxed) amount of 90,000 but levy a tax (of 1,500) on the "untaxed" amount of 10,000, leading to an overall tax burden of 19,500.

One might argue against this consideration that the exemption method in other situations does not necessarily mean less tax either, particularly in situations where (exempted) foreign losses are not taken into account in the state of residence. However, such a conclusion is not compelling, considering that the application of a subject-to-tax clause to single receipts untaxed in the state of source will lead to additional tax (on these additional foreign receipts) in the state of residence. The effect of the exclusion of foreign losses in the state of residence by virtue of the exemption method, on the

36. Since 2008, Germany's nominal corporation tax rate is 15% (excluding trade tax, which is not levied on foreign PE results, and solidarity surcharge). Comparing this rate with other countries' corporation tax rates (e.g. a nominal rate of 20% in the United Kingdom since 1 April 2015), Germany's rate should be one of the lowest.

contrary, is limited to income already taxable in the state of residence, thus not subjecting additional foreign income to tax in the state of residence.

If the income in question is derived from only one source in the other contracting state (e.g. from one PE or from one employment), the application of the credit method on the aggregate income from said source respects the features of the other state's tax system in its entirety, in particular the balance of a more or less comprehensive tax base and the applicable tax rate. There seems to be no good policy reason for a different approach under the exemption method.

16.3. No effective taxation in the state of source

The second major difficulty when applying a subject-to-tax clause is the unclear meaning of income (or parts thereof) being "taxed", "actually taxed" or "effectively taxed" in the other state ("*tatsächlich*", hereinafter "effectively").

No. 4 of the protocol to the GNB explains, "It is understood that items of income or capital, or elements thereof, are taxed when they are included in the taxable base by reference to which the tax is computed. They are not actually taxed if they are either not taxable or exempt from tax".

In addition, the circular on subject-to-tax clauses requires the inclusion of the income in the taxable base.[37] Generally, this abstract statement, followed by several examples specifying when such inclusion in the taxable base is or is not present, is a progress compared with the many previous circulars[38] that did not include such an abstract clarification.

However, the circular does not specify whether mere taxation or effective taxation is required for the exemption to apply, although the wording of the subject-to-tax clauses in existing German treaties differs in this regard. From the circular's examples,[39] however, one may infer that the subject-to-tax clause generally requires effective taxation in order to obtain exemption.

37. *See* DE: BMF, *supra* n. 16, at para. 2.3(a).
38. *See* primarily the circulars and the paragraphs cited in n. 23.
39. *See* DE: BMF, *supra* n. 16, at para. 2.3(a) (b).

Although the circular deals with (existing) tax treaties, one may assume that it equally reflects the tax administration's position with regard to the subject-to-tax clause in the GNB.

16.3.1. Taxation

After its abstract definition of effective taxation in the state of source, the circular provides examples of situations in which taxation in the sense of subject-to-tax clauses takes place (and thus exemption applies), although tax is effectively not levied.

16.3.1.1. Allowances, loss set-offs and credits/deductions of foreign taxes

This includes situations where no tax is levied due to allowances (*Freibeträge*, tax exempt amounts) or due to a set-off against losses of the current assessment period (*Verlustausgleich*) or losses carried forward or backward (*Verlustabzug*). This approach was advocated already in earlier circulars[40] and is supported in German professional tax literature.[41] The circular does not distinguish between personal allowances (e.g. as regards the minimum income needed to exist) and allowances reserved for specific income categories. Taxation also occurs if no tax is levied due to the crediting or deduction of foreign, i.e. third-country, taxes in the state of source.

16.3.1.2. Privileged dividends

The circular provides that taxation also occurs in situations in which dividends are covered by the Parent-Subsidiary Directive[42] or a treaty participation exemption[43] and are thus privileged. This is remarkable given the fact that the same circular advocates the application of the subject-to-tax

40. *See* the circulars and paragraphs cited in n. 23.
41. J. Schönfeld & N. Häck, Art. 23A/B OECD Model, in Schönfeld & Ditz, *supra* n. 19, m.no. 78. *See also* J. Holthaus, *Systemwechsel in der Abkommenspolitik: tatsächliche Besteuerung im Quellenstaat Voraussetzung für Freistellungen nach den neuen DBA*, 21 Internationales Steuerrecht 14, at p. 539 (2012), who concludes that no effective taxation occurs where no tax is paid because of allowances (*Freibeträge*).
42. *See* articles 4(1) and 5 of Council Directive 2011/96/EU of 30 Nov. 2011, last modified by Council Directive 2015/121/EU of 27 Jan. 2015.
43. To agree a participation exemption (*Schachtelprivileg*) in order to avoid economic double taxation in a tax treaty's article on the avoidance of double taxation in the

clause in situations in which an objective tax exemption applies,[44] because articles 4(1) and 5 of the Parent-Subsidiary Directive, as well as treaty participation exemptions, provide for objective tax exemptions. The result therefore appears to be a distinction between "good" and "bad" objective tax exemptions. In addition, the protocol to the GNB[45] suggests including language to safeguard the non-application of the subject-to-tax clause for dividends that are exempt under the Parent-Subsidiary Directive.

Yet the non-application of subject-to-tax clauses in situations covered by a treaty's participation exemption or the Parent-Subsidiary Directive should not be deduced from the subject-to-tax clauses' or from express exclusions' wording, but rather from the object and purpose of any dividend exemption, which is the prevention of economic and/or juridical double taxation. Article 5 of the Parent-Subsidiary Directive, as well as tax treaties' distributive provisions precluding (or limiting) the source state's right to tax dividends, avoid juridical double taxation, whereas article 4(1) of the Parent-Subsidiary Directive and participation exemptions in the article for the avoidance of double taxation in the residence state prevent economic double taxation. Applying the subject-to-tax clause to such privileged dividends would defeat this aim and lead exactly to double taxation.

In addition, domestic law itself may provide for an absence of withholding tax on dividends[46] or a (participation) exemption on the occasion of receipt of dividends.[47] However, the aim of such provisions, the avoidance of double taxation, is the same. To apply a tax treaty's subject-to-tax clause to dividends in such situations and thus to counteract the contracting state's preferential treatment of dividends appears questionable in light of these considerations. This applies also where section 8b(4) of the German

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residence state is established German treaty policy, *see* Lüdicke (IBFD 2010), *supra* n. 9, sec. 3.2.2., at p. 279. A participation exemption is also foreseen in article 22(1)(a)(2) of the *Verhandlungsgrundlage* (participation threshold of at least 10%).

44. *See* DE: BMF, *supra* n. 16, at para. 2.3(b), first indent.

45. *See* the text between no. 3 and no. 4 of the protocol, which, according to its footnote 4, "(m)ay be required in the case of EU Member States": "The exemption for dividends shall not cease to apply because the dividends are not taxed in [jurisdiction] on account of the Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (90/435/EWG) in the respective applicable version".

46. For instance, UK domestic law does not levy withholding tax on dividends. On the other hand, Germany does not levy withholding tax on most of the straightforward interest from German sources.

47. For example, German corporation tax law contains in section 8b(1) of the German Corporation Tax Code a participation exemption for receipts such as dividends. Due to section 8b(4) of the same act, the participation exemption only applies if the participation amounts at the beginning of the calendar year to at least 10%.

Corporation Tax Act provides for taxation of portfolio dividends, i.e. where the underlying participation is, inter alia, less than 10%, whereas the tax law of the other contracting state exempts the dividends derived in and attributable to a foreign PE that is exempted according to the tax treaty between Germany and that state. Applying the subject-to-tax clause to such dividends would lead to contradictions compared with situations where the other contracting state does not exempt such dividends but provides for an indirect tax credit for taxes paid in the state of the distributing company, because the circular expressly states that taxation takes place in the other contracting state if no tax is levied due to the deduction or crediting of foreign taxes.[48]

Dividend taxation may serve as one good example to demonstrate that it requires thorough and well-informed considerations of whether the absence of taxation in one state should give rise to countermeasures by any other state.

16.3.1.3. Differing rules on income calculation

Differences may result from the application of different rules in the contracting states on the calculation of the taxpayer's income. Such differences may be permanent (e.g. the other state allows deductions not available under German tax law) or temporary (e.g. different rules as regards provisions or depreciation). According to the circular, both types of differences do not prevent the "income" from being taxed in the other state.[49]

It is hard to reconcile the German tax administration's position in this regard with the aforementioned statements regarding tax-free gross receipts. Economically, there is no difference between a permanent difference caused by a deduction for an expense which is available only in the source state and a permanent difference caused by a tax exemption of an item of income that is granted only by the source state.

Again, from a policy perspective, one may wonder whether the application of a subject-to-tax clause only in the latter case can be justified. Such an approach, however, would require that receipts are considered on a "per item and parts thereof" basis, whereas expenses are not taken into account on an individual basis.

48. *See* section 16.3.1.1.
49. *See* DE: BMF, *supra* n. 16, at para. 2.3(a).

The entire circular does not mention transactions performed at book value in the other contracting state. Such transactions may take place with respect to the same taxpayer (e.g. a rollover of hidden reserves from one asset of the taxpayer to another) or between different taxpayers (e.g. a transfer of an asset at book value from one taxpayer to another in the course of a restructuring). Such transactions only defer taxation but do not result in an absence of taxation as such, which is why they should not trigger tax treaties' subject-to-tax clauses. As the unspecified and therefore too broad wording of the existing clauses covers such transactions at book value, the clauses constitute the danger of effective international double taxation. Recent practice shows that tax offices argue for the application of subject-to-tax clauses in such situations. Against this background, the clauses turn out to be a serious impediment for international structures of German-based enterprises.

16.3.2. Non-taxation

As referred to above, the circular mentions several categories leading to non-taxation in the other contracting state, with the consequence that the subject-to-tax clause applies if its other conditions are met.[50] Generally, this is considered to be the case where income cannot be taxed according to domestic law or effective taxation does not occur due to other reasons.

16.3.2.1. Domestic law does not provide for taxation

This first category[51] deals with income that is not taxable or objectively tax exempt, as well as situations where taxpayers are personally tax exempt.

As objective tax exemptions often relate only to "elements" of income of one category under the treaty, the "atomization" of income is of particular importance in this regard. Reference is made to the discussion (*see* section 16.2.3.) of the German tax administration's new approach.

A personal tax exemption is also considered to lead to non-taxation. As it is rather rare that a state in its position as source state provides for personal tax exemptions for non-residents, it is difficult to determine this aspect's potential scope.

50. Id., at para. 2.3(b).
51. Id., first indent.

With regard to objective tax exemptions, no distinction is drawn between general tax exemptions for certain income (e.g. a capital gain resulting from a disposal of private assets after a holding period has elapsed) and situations not covered by the scope of the limited tax liability of non-resident taxpayers (e.g. dividends in the United Kingdom). In particular, the first category is the consequence of a state's sovereignty to define taxable events that must not necessarily cover all kinds of business transactions and may be different from other states' sovereign decisions. The principle that tax treaties also avoid "virtual" double taxation[52] respects such sovereign decisions not to tax certain events and to tax others. On the other hand, a restriction of the scope of the limited tax liability may in some situations be considered a tax incentive targeting (at least) mainly foreign investors. Such measures may then be qualified as so-called harmful tax practices,[53] against which a countermeasure in the state of residence may, as the case may be, be appropriate. However, this justification has no impact on the lack of a legal basis for the "atomization" of income in existing tax treaties' subject-to-tax clauses (*see* section 16.2.3.); moreover, one must be aware that much sensitivity is often required to draw a dividing line between what constitutes a harmful tax practice and what constitutes a legitimate exercise of a state's tax sovereignty.

16.3.2.2. Other factors leading to non-taxation

In the absence of any such discussed tax exemptions, other factors may also lead to the kind of non-taxation rejected by the tax administration. These include the other contracting state's lack of knowledge of elements of items of income. For example, an employee working in the other contracting state may have forgotten to declare such an element (e.g. a night-shift premium) forming part of his remuneration that is taxable in that other state. Although advocated in the circular, one may doubt whether the application of subject-to-tax clauses to such situations is the appropriate instrument, at least in situations where the tax treaty also provides for spontaneous information exchange between the state of residence and the state of source.

52. OECD Commentary on Articles 23A and 23B (15 July 2014), para. 34.
53. OECD, Harmful Tax Competition: An Emerging Global Issue, 1998, p. 25 et seq. *See also* OECD, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report.

16.3.3. Foreign losses

German courts interpret tax treaties' articles for the avoidance of double taxation in the state of residence in such a way that not only profits but also losses are exempted in Germany if the tax treaty provides for the exemption method for such an income category in Germany as the state of residence (the so-called symmetry thesis).[54] However, when losses arise in the other contracting state, and consequently no tax is due on the negative income, or even on other positive income, the application of a subject-to-tax clause leading to the "taxation", i.e. deduction, of those losses in Germany has to be considered.[55]

The circular restricts the recognition of losses due to a subject-to-tax clause to cases where the taxpayer gives evidence to the fact that the losses are not recognized at all in the other state in the same or in another period because they belong to a category of income that is not taxed in the other state.[56] This appears consistent to the extent that not an obligation to pay taxes, but the inclusion of income in the foreign taxable base, is crucial. However, a foreign loss will only rarely have to be considered in Germany on the basis of this approach. Nevertheless, this should be the case, for example, where the other state does not tax certain disposals of private assets and therefore does not recognize losses due to such disposals for tax purposes, whereas German tax law would tax capital gains (and losses) from such transactions.

Considering expenses, the position appears less consistent. The circular provides that foreign negative income, i.e. losses, triggers the subject-to-tax clause if it definitely and completely cannot be taken into account in the other contracting state. This refers to the current assessment period, as well as previous and subsequent assessment periods. With respect to gross receipts, the subject-to-tax clause, as interpreted by the tax administration, applies to each untaxed receipt. This, symmetrically, should equally apply to single expenses that are not taken into account in the other contracting state, one might assume. However, according to the circular, the only reason for the non-consideration of the expenses abroad must be that they belong to a category of (net) income (or are related to such a category) that – as a whole – is not taxable abroad.[57] Conversely, if the (net) income category

54. Rust, *supra* n. 4, at para. 23 and n. 41; Lüdicke (IBFD 2010), *supra* n. 9, at p. 282.
55. *See* OECD Commentary on Articles 23A and 23B (15 July 2014), para. 35: "[T]ax is not effectively collected owing to special circumstances such as the set-off of losses".
56. *See* DE: BMF, *supra* n. 16, at para. 2.5(b).
57. *See* DE: BMF, *supra* n. 16, at para. 2.5(b): "*weil sie zu einer dort nicht besteuerten Kategorie von Einkünften gehören oder mit diesen in Verbindung stehen*".

is generally taxable, but single expenses are not deductible (e.g. due to restrictions of deductions pursuant to domestic law), the subject-to-tax clause would not apply. The result would be that the expense is considered neither in the other contracting state (source) nor Germany (residence), whereas a gross receipt not taxed in the other contracting state would be taxed in Germany due to the subject-to-tax clause. This different treatment of gross receipts and expenses seems inconsistent and also argues against the "atomization" of net income from a single source as advocated by the administration.

16.4. Evidence

The third practically important question of subject-to-tax clauses relates to how the taxpayers can prove that their (elements of items of) income is (are) or was (were) taxed in the other contracting state. As the taxation in the other state is a requirement for the exemption under the tax treaty, the burden of proof lies with the taxpayer. Generally, according to the circular,[58] proof is required to be provided in the form of the tax assessment notice of the foreign tax office and a proof of payment of the taxes due (transfer or deposit receipt issued by a bank or the tax office). In case the other contracting state does not issue tax assessment notices, because tax is self-assessed, a proof of payment and a copy of the tax return are considered to be sufficient.

In the absence of a tax assessment procedure in the other contracting state (e.g. withholding wage tax), "effective" taxation in that state can be demonstrated by means of a document confirming that the tax is withheld at source, according to the circular.

It is doubtful whether such requirements are practicable and reasonable. In particular, it is not clear if further documents have to be provided by the taxpayer in light of the fact that, notably, a foreign tax assessment in a foreign language might not disclose each single gross receipt (e.g. the absence of tax-exempt interest or investment allowances as parts of the profits of a PE or the absence of tax-exempt premiums paid to employees in addition to their regular salary). Obviously, the question of how a German tax authority in such circumstances would become aware of such tax-exempt gross receipts arises. A general suspicion that certain receipts have remained untaxed abroad seems likely but should be disapproved of.

58. *See* id., at para. 2.4.

This formal aspect also argues against the "atomization" of income as advocated by the German tax administration. In particular, its practical enforcement demands requirements both with respect to enquiries by tax administrations and proof by taxpayers that counteract the exemption method's administrative advantages. It remains to be seen whether subject-to-tax clauses will be handled reasonably by tax administrations in situations in which evidence cannot be (or cannot completely be) supplied.

16.5. Conclusion

The foregoing reflections in honour of Jörg Manfred Mössner have shown that subject-to-tax clauses are problematic both from a conceptual point of view as well as in practical terms. They may be regarded as a particularly significant example of an "all or nothing" policy.[59] Consequently, they are not apt to reflect the details of and the correlation between autonomous rules of the other state's tax system. By referring to the "taxation" of items of income or capital, or even to elements thereof, such clauses disregard the other state's policy reasons for not taxing these, and, in particular, they disregard potential balancing measures like a higher tax rate for the residual income or capital or a later inclusion in the same or another taxpayer's tax base. Being a "digital" switch, they cannot cope with tiny differences like that between (very) low and no taxation, or like that between exempting an item of income on the one hand and technically taxing it while granting a deduction of the same amount on the other hand. The practical application of the respective rules by taxpayers and tax administrations, and the fact-finding and providing of evidence where required, may turn out to be anything but easy to handle.

One should not expect newly developed provisions like "linking rules", as suggested by the BEPS project,[60] making taxation (in particular, deduction of payments) in one state dependent on a specific treatment of these payments either as expenses (double deduction) or even as other taxpayers' items of income (deduction/non-inclusion) in another state, to be conceptually easier to formulate and in practice easier to administer. Although the denial of a deduction as part of the OECD's solution ("primary response"), as well as the linking rules in general, seem to provide a straightforward

59. *See* J. Schwarz, *Schwarz on Tax Treaties* sec. 25/400 (Kluwer, 4th edn. 2015).
60. OECD, *supra* n. 6.

solution to the problems resulting from hybrid mismatch arrangements, the report's 458 pages illustrate the issues' difficulties.[61]

Looking at the subject-to-tax clauses in German tax treaties and the discussion of their merits, deficiencies and the lessons to be learned may help to unveil some potential pitfalls of domestic countermeasures contemplated or introduced by other states against isolated effects of foreign tax systems.

61. Id.