

Law Firms
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"Revival" of the subject-to-tax clause in the 1989 DTT USA?

German Federal Fiscal Court decision dated October 17, 2007 on the subject-to-tax clause in the DTT Italy

The German Federal Fiscal Court stated in its decision dated October 17, 2007 that Art. 24 para. 3 letter a of the 1989 double tax treaty between Italy and Germany (DTT Italy) contains a subject-to-tax clause. The Court had to rule on whether a German resident had to pay taxes in Germany on a gain resulting from the conversion of an Italian partnership into an Italian corporation, which was a tax neutral transaction under Italian tax law.

Review of the Decision

This decision could have an impact on structures established to create "white income" which rely on the interpretation that the 1989 DTT USA (in effect until the end of 2007) does not contain an effective subject-to-tax clause.

Generally, German tax treaties rely on the exemption method to avoid the double taxation of income also subject to tax in a foreign country.

In the past, the German tax authorities took the position that under the subject-to-tax clause of the 1989 DTT USA, only U.S. income that had "actually" been taxed by the U.S. would be exempted from German taxation. In a German Federal Fiscal Court decision dated December 17, 2003, which related to the application of the German-Canadian tax treaty and in which its earlier jurisprudence was abandoned, the Federal Fiscal Court decided that a provision in the Canadian tax treaty which in the past had been viewed as a subject-to-tax clause and whose wording was comparable to that contained in Article 23 Subsection 2 second sentence of the DTT USA 1989, should no longer be viewed as a subject-to-tax clause.

Some German Supreme Finance Directorates followed this decision in two directives and also applied it to the 1989 DTT USA. Furthermore, a draft decree on the application of treaties to partnerships expressly states and confirms the view of the German tax administration that the 1989 DTT USA does not contain a subject-to-tax clause and that the above-mentioned court decision from 2003 should be applied.

Contrary to this, the recent court decision dated October 17, 2007 stated that the DTT Italy contains an effective subject-to-tax clause and also explicitly stated that it no longer adheres to its 2003 decision in which the existence of a subject-to-tax clause was denied. The wording of the subject-to-tax clause in both treaties (Italy and USA) is similar with the exception that the DTT Italy explicitly requires an effective taxation in the other country. Therefore, it remains to be seen whether and how the German tax administration will apply this decision to the 1989 DTT USA.

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The Competence Center consists of tax advisors, tax lawyers, accountants, German certified public accountants and assistant tax consultants. All team members have extensive experience in advising on international tax law matters. Ongoing tax compliance services such as preparing tax returns for the firm or resident and non-resident partners as well as tax structuring and tax planning services are the main aspects of the team's activity in advising its more than 20 law firm clients.

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