KPMG

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Ministerial Draft Bill for an Act on the Implementation of the ATAD

The Federal Ministry of Finance [BMF] has published the ministerial draft bill for an Act on the Implementation of the Anti Tax Avoidance Directive (ATAD Implementation Act). In 2016, the EU enacted the so-called ATAD (Anti Tax Avoidance Directive) containing a package of legally binding measures to combat tax avoidance, to be implemented by all EU Member States. According to the explanatory memorandum to the Act, Germany largely fulfills the minimum standards established by the ATAD already today, however, in certain areas there continues to be need for adjustment. The present draft bill is intended to implement provisions of the ATAD regarding Exit taxation (Article 5 ATAD), CFC rules (Articles 7, 8 ATAD) and Hybrid mismatches (Articles 9, 9b ATAD). Moreover, the provisions on the arm's length principle under §§ 1,1a,1b of the Foreign Transactions Tax Act [AStG] shall be amended, and a legal basis for advanced pricing agreements shall be established. In the following some important changes will be presented roughly.

1. Exit taxation

Tax involvement

Where a taxpayer moves assets or a corporation relocates to Germany, the principles governing the initial valuation of the moved assets are changed. Henceforth, the initial valuation shall correspond to the valuation in the other state. The assets shall be assessed at the value which the other state takes as tax base (there: exit taxation), however, not exceeding the fair market value. The new provisions shall first be applicable to fiscal years ending after 31 December 2019.

Balancing item in cases where assets are moved

Even non-resident taxpayers shall henceforth be able to spread out their tax payments in case of an exit taxation (see above) in cases where assets are moved to an EU/EEA permanent establishment (by using the possibility to form a balancing item according to § 4g Income Tax Act [EStG]). Moreover, the application shall no longer only be limited to fixed assets. The catalogue of circumstances leading to an immediate release of the balancing item shall be extended.

Content

The new provision shall be applicable to all open cases.

2. Reform of the CFC rules

Significant changes regarding the German CFC rules are the change of the control criterion as well as introduction of a shareholder-based approach, the elimination of the concept of lower tier intermediary companies (direct income inclusion concept) and the revision of the catalogue of active income. Furthermore, the motive test ("Cadbury Schweppes" test) shall be revised and extended for certain passive income to non-member countries and a new date of inclusion of the foreign income in the German tax base shall be implemented.

Control

Control shall henceforth be given if a resident taxpayer, alone or jointly with **related persons,** holds a majority stake in the foreign company (**shareholder-based approach)**. The current concept of the so-called domestic control by adding up the participations of all resident taxpayers is thereby abandoned. Through the involvement of (indirect) participations of related persons shall henceforth also include cases of CFC taxation which are not taken into account in the application of the currently applicable pure concept of domestic control (e.g. participation of a German subsidiary GmbH of 49% and the French group parent company of 2% in an intermediary company, together 51%). In addition to direct participations, also **indirect participations** in the foreign company are now to be taken into account so that the income of a lower tier intermediary company is directly attributed to the resident taxpayer.

Catalogue of active income

The concept of the active income catalogue shall be retained. According to this concept, any low-taxed income is considered to be subject to the CFC rules (passive) if the activity from which the income is derived is not expressly defined as active. Although the ATAD establishes a catalogue of passive income, a conversion in this regard is, according to the draft, however, not required.

Low taxation

Low taxation shall further on be given if the income of the foreign company is subject to an income tax burden of less than 25%.

Time of application

The revision of the CFC rules shall first be applicable for the assessment period for which intermediary income is to be imputed that accrued in a fiscal year of the intermediary company commencing after 31 December 2019.

3. Hybrid mismatches

The present draft bill is to transpose provisions basically through a new § 4k EStG-E [draft income tax act]. The scope of application shall be limited to payment relationships between related persons or between an enterprise and its permanent establishment as well as to structured arrangements. Rules shall apply to limit the deduction of operating expenses for certain hybrid arrangements in the following cases:

1. **Deduction/Non-Inclusion mismatches:**

- In connection with so-called **hybrid financial instruments**, i. a. hybrid bonds, profit participation rights etc. According to the explanatory memorandum, this is particularly the case if in Germany and the recipient state a different tax qualification of capital assets is applied (e.g. interest expenses vs. dividend income) so that the recipient is taxed at a more favorable rate. So-called **hybrid transfers,** where the underlying income from a transferred capital asset is economically attributed to more than one person involved in the transfer (different attribution of capital assets for tax purposes), shall also be captured.

- In the context of payment relationships (e.g. interest, royalties, rental and services expenses) between a **hybrid legal entity** and its shareholder or between **permanent establishments** of an enterprise to the extent that the income is not subject to de facto taxation due to a different tax treatment of the legal entity or a different profit split.

- Further D/NI mismatches not captured by the aforementioned cases, in particular so-called **reverse hybrid legal entities** who are treated as transparent legal entities in the state of their establishment, as non-transparent legal entities in the state of the direct or indirect participants, as well as due to a **different allocation of income** to individual parts of the enterprise.

2. **Deduction disallowance in the event of Double Deduction mismatches:** in many cases, these are based, according to the explanatory memorandum, on a payment made by a hybrid legal entity or a permanent establishment to which the tax credit method is applicable to a foreign third-

party. A special hybrid element, however, shall not be required.

3. **Imported taxation mismatches:** this shall refer to situations where an effect of a taxation mismatch which has arisen among other states, and who failed to eliminate this mismatch, is imported into Germany in whole or in part.

The new provisions shall be applicable **for the first time** to expenses arising **after 31 December 2019**.

The provisions on hybrid arrangements shall be accompanied by amendments of the **tax exemption** of **dividends** of **§ 8b (1) Corporate Income Tax Act** [KStG] – first application for income accruing after 31 December 2019 – **and of the restriction of the DTT exemption method (first application** as from assessment period 2020).

4. Arm's length principle

The provision on the adjustment of income (§ 1 AStG) shall be closer aligned to the **OECD transfer pricing guidelines**. The proposed changes are intended to clarify and highlight substance over form and provide general rules, benchmarked against international practice, for the determination and verification of transfer prices. In order to determine the arm's length price, first the actual price-impacting circumstances underlying the respective transaction to be examined must be determined by way of a function and risk analysis as well as a comparability analysis. At the same time, specific particularities – circumstances which cannot be agreed – of a group shall be considered. Regarding the **transfer pricing documentation,** the threshold for the preparation of the so-called "master file" shall be reduced from 100 million to 50 million Euros. Moreover, taxpayers shall henceforth be required to electronically submit the records to the local tax authority within the fiscal year following each fiscal year at the latest.

Financing relationships

A considerable amendment is the new **§ 1a AStG-E** providing for an income adjustment for **cross-border financing relationships** between related persons.

The income adjustment shall be subject to an expense resulting from a cross-border financing relationship (e.g. loan) within a multinational group of companies and subject to the condition that

1. the taxpayer cannot credibly show that (a) from the outset, it could have serviced the debt for the entire financing term and (b) the financing is economically required and used for the business purpose

   or

2. the agreed interest rate exceeds the interest rate at which the multinational group as such could finance itself vis à vis third parties unless the taxpayer provides evidence that another value corresponds to the arm's length principle.

The new provision moreover provides for a legal classification of the **pure intermediary service** or **forwarding** of a financing relationship, the typical **treasury function** and the **cash pooling** as **a low-function and low-risk service** which is to be compensated accordingly (low). The compensation for such transactions shall be limited to the risk-free interest rate which is to correspond to the term-equivalent interest rate of top-rated government bonds.

Time of application

The amended provisions on the arm's length principle pursuant to §§ 1 and 1a AStG-E shall first be applicable already for the assessment period 2020.

The lowering of the threshold for the preparation of the master file shall be applicable as of 1 January 2021. The first application of the changed filing requirement for the records may be prescribed by the BMF by ordinance.

5. Outlook

With the publication of the ministerial draft bill, the BMF has initiated the legislative proposal. The publication of the government draft bill follows subsequently, on which the Bundesrat [upper house of the German parliament] is entitled to comment. The decisions of the Bundestag [lower house of the German parliament] and the Bundesrat follow thereafter.

Federal Tax Court (I R 5/17, 32/17 and I R 54/17): Precluding Effect pursuant to Article 9(1) of the OECD Model Tax Convention

In its former judgment of 27 February 2019 (I R 73/16), the German Federal Tax Court [BFH] decided that – contrary to prior judgments – elimination of a profit-reducing derecognition of an unsecured intragroup loan pursuant to Section 1(1) of the German Foreign Transactions Tax Act [AStG] is not precluded pursuant to Article 9(1) of the OECD Model Tax Convention

Previously, the BFH had assumed for items subject to a double taxation agreement (tax treaty) that Article 9(1) of the OECD

Model Tax Convention is limited to so-called price adjustments, with elimination of a profit-reducing derecognition of a loan receivable or write-down to fair value, on the other hand, being precluded (so-called overriding effect). The BFH now sees this differently. The lack of collateralisation represents non-arm's length (loan) terms and the profit-reducing derecognition by the German limited liability company must be rectified in any event pursuant to Section 1 (1) AStG. This is not precluded by Article 9(1) of the OECD Model Tax Convention.

This decision has major implications for the financing of foreign subsidiaries by domestic shareholders. On 19 June 2019, the BFH ruled on three further cases concerning the lack of collateralisation in connection with cross-border (loan) receivables:

In the I R 5/17 case, the BFH did not recognise the write-down to fair value of a receivable from a subsidiary (Switzerland), as the loan was unsecured and only an interest spread rather than a fixed interest rate was agreed. In the I R 54/17 case the write-down to fair value of a receivable from a subsidiary (United Kingdom) was not recognised because no collateral was provided for the current account loan for initial financing and the interest rate of 6.5% was not increased discernibly. In both cases the BFH ruled as in the I R 73/16 case, concluding that an income adjustment pursuant to Section 1 of the AStG must be made.

In the I R 32/17 case, write-downs to fair value of receivables from subsidiaries (France and USA) were disputed. The underlying loans were also unsecured and in some cases subject to a fixed interest rate, while in some cases interest was charged in the amount of a share of the retained earnings of the borrower. In addition, in the case under dispute there was a reduction in profits resulting from a transfer of assets to a Maltese subsidiary at book value. The BFH remitted the case to the lower court, as it must be established whether the loans in this specific instance were granted on an arm's length basis. In addition, with regard to the transfer of the assets, it would have to be reviewed whether this constitutes an agreement under company law leading to a change in material shareholder status. In the latter case, there would be no 'business relationship' within the meaning of the AStG that could be amended according to the AStG.

Lower Tax Court of Lower Saxony (10 K 188/17): Trade Tax Add-Backs when Renting a Trade Fair Stand

With its judgment of 6 December 2018 (10 K 188/17), the Lower Tax Court of Lower Saxony ruled that the costs of renting a trade fair stand are subject to adding back for trade tax purposes.

In principle, every trading entity operated domestically is subject to German trade tax. Trade tax is calculated based on trade income. According to the German Income Tax Act and/or German Corporate Income Tax Act, trade income refers to profit from business operations, which is increased or decreased through add-backs or reductions pursuant to the German Trade Tax Act. In particular, rental expenses for the use of an immoveable fixed asset owned by another person are to be added back to trade income (Section 8 no. 1 lit. e of the German Trade Tax Act).

The complainant (GmbH) develops, produces and markets certain goods in its business operations. In the years under dispute of 2014 and 2015, the complainant presented their range of goods at various trade fairs.

The disputed issue was whether the cost measured by square metre of renting the trade fair stands was subject to trade tax add-back.

The Lower Tax Court of Lower Saxony affirmed the adding back for trade tax purposes in the case at hand, stating that the rule required in particular a "fictitious" allocation to the fixed assets of the lessee. It is fictitious because the rented asset cannot be allocated to the operating assets of the lessee because they do not own it. This is to be based on whether the immoveable assets would be fixed assets of the lessee if the lessee were the owner (so-called fictitious fixed assets).

When examining whether fictitious fixed assets exist, the business purpose of the company must be taken into account. The question is whether the business purpose requires the permanent holding of such assets. It does not, however, depend on the duration of the rental, meaning that an asset can also be a fictitious fixed asset if it is only hired out for a short time.

According to these principles, the Lower Tax Court of Lower Saxony stated that the rented trade fair stands in the present case did form part of the fictitious fixed assets of the complainant. The complainant's business purpose is not only the production but also the marketing of goods. It is therefore necessary for the complainant to frequently present its products at various trade fairs. The purpose of being the fictitious owner of these plots would therefore be to support business operations on an ongoing basis, even if this is potentially only for a brief period during the year.

The Lower Tax Court of Düsseldorf (judgement dated 29 January 2019, 10 K 2717/17 G) however in a similar case rejected the adding back for trade tax purposes of expenses for renting a trade fair stand. However, the trade fair in which the complainant took part only took place every three years and the complainant primarily marketed the products it produced through other sales channels. For this reason, the Lower Tax Court of Düsseldorf denied the existence of fictitious fixed assets.

While the judgement of the Lower Tax Court of Düsseldorf is still pending at the Federal Fiscal Court under reference number III R 15/19, the judgement of the Lower Tax Court of Lower Saxony is final and absolute.

Frankfurt Regional Tax Office: Recognition of a Consolidated Tax Group with an EU/EEA Corporation with Management in Germany

The Frankfurt Regional Tax Office has issued a statement on the recognition of a consolidated tax group with a corporation founded in an EU/EEA country other than Germany with management in Germany.

The residency requirements for a controlled entity in a tax group consist of the company having its management based in Germany and a registered office in a member state of the European Union or a contracting state in the Agreement on European Economic Area (EEA) (Section 14 (1) sentence 1 of the German Corporate Income Tax Act). The requirement of so-called "double territoriality" (registered office and management located in Germany) was lifted with the "minor tax consolidation reform" in 2013. Further, conditions for recognition as a consolidated tax group include the conclusion of a profit and loss transfer agreement pursuant to Section 291 (1) of the German Stock Corporation Act [AktG].

In the decree dated 12 November 2019, the Frankfurt Regional Tax Office communicated the result of the discussions between representatives of the federal and state governments regarding recognition of international profit and loss transfer agreements. According to this, such agreements are to be recognised if the provisions of the profit and loss transfer agreement

- are fully in line with the requirements of Section 291 AktG and, in particular, also contain an obligation to assume losses in accordance with the regulation under Section 302 AktG,
- are permissible under foreign (civil) law (in particular compatible with local commercial and corporate rules for the protection of creditors and minority shareholders),
- are agreed in a form subject to mandatory registration, i.e. there is either under foreign law an obligation to enter the regulations into a public register comparable to the German commercial register, or the regulations regarding the transfer of profits are added to the articles of association of the controlled company and there is a requirement under foreign law to register amendments to the articles of association,

and

- if the profit and loss transfer itself is not enshrined in the articles of association, are similar in nature to an amendment of the articles of association (a mere additive change to the articles of association is insufficient).

If the aforementioned criteria are met, the consolidated tax group must be recognised at the earliest from the year in which it is entered into the commercial register. This applies also in cases where a profit and loss transfer agreement was already concluded earlier.

This national administrative pronouncement is considered to be the first public response from the tax authorities to the infringement case initiated by the European Commission against the Federal Republic of Germany. In July 2019, the Commission requested that Germany recognises profit and loss transfer agreements that have been concluded under the law of another EU or EEA Member State. Previously, companies founded in accordance with the law of another EU or EEA Member State that relocated their administrative headquarters to Germany were de facto unable to meet the formal commercial register entry requirements to have such agreements recognised. The new administrative ruling is intended to end this unequal treatment.

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