

German Tax Monthly

Information on the latest tax developments
in Germany

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Bundesrat passes ATAD Implementation Act

On 29 June 2021, the upper house of the German parliament (Bundesrat) passed the **Act Implementing the EU Anti-Tax Avoidance Directive (ATAD Implementation Act (ATADUmsG))**.

The present act is intended to implement the following ATAD provisions in Germany: Exit taxation (Article 5 ATAD), CFC rules (Articles 7, 8 ATAD) and Hybrid mismatches (Articles 9 and 9b ATAD).

Transfer taxation

In the case of **transfer**, where a taxpayer moves assets or a corporation relocates to Germany, the principles governing the initial valuation of the transferred assets are changed. In future, the initial valuation corresponds to the valuation in the other country. The assets are assessed at the value which the other country takes as tax base (there: exit taxation), however, not exceeding the fair market value.

The act provides for a separate timeframe for application of the

new provisions, according to which these are to be applied retroactively for financial years ending after 31 December 2019.

Balancing items according to § 4g Income Tax Act [EStG]

In future, non-resident taxpayers will also be able to form a **balancing item according to § 4g** of the German Income Tax Act when transferring assets to an EU/EEA permanent establishment. Moreover, the application will no longer only be limited to fixed assets. The catalogue of circumstances leading to an immediate **reversal** of the **balancing item** will be extended.

On the other hand, the **tax-neutral reversal** of a balancing item when retransferring the assets will be **discontinued**.

The new provision will be applicable to all open cases.

Reform of CFC rules

The CFC rules of the AStG are to prevent the tax-induced shifting of passive income to low-tax jurisdictions. The ATAD Implementation Act substantially revises the CFC rules.

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Significant changes are:

- Change of the **control criterion** as well as introduction of a shareholder-based approach
- Elimination of the concept of lower-tier intermediary companies (**direct income inclusion concept**)
- Revision of the **catalogue of active income**
- Revision and extension of the **motive test** for certain passive income also to third countries
- Notification requirement instead of tax return requirement, to the extent that the motive test can be performed
- **Earlier date** for inclusion of foreign income in the German tax base.

The Act does not provide for a new **low tax rate limit**. If the income tax burden is **lower than 25%**, low taxation continues to be applicable for the time being. According to the explanatory memorandum, this is intended "not to pre-empt the outcome of promising consultations regarding the introduction of a global minimum tax rate (GloBE) at OECD level by unilateral regulations".

The amendment of the CFC rules will first be applicable for the assessment or tax collection period for which intermediary income is to be added that accrued in a fiscal year of the intermediary company **commencing after 31 December 2021**.

Hybrid mismatches (taxation mismatches)

Hybrid mismatches are based on differences in the legal

characterisation of payments (financial instruments) or companies/permanent establishments between two countries. This may result in tax deduction in both countries (so-called **Double Deduction**) or a deduction in one country without inclusion in the tax base of the other country (so-called **Deduction/Non-Inclusion**). It is against this background that the ATAD lays down rules to neutralise the effects of taxation mismatches (Articles 9 and 9b ATAD). The Act transposes these provisions essentially through a new **§ 4k EStG-E** [draft Income Tax Act]. The scope of application will be limited to intercompany transactions between related parties as defined by § 1 (2) AStG or between an enterprise and its permanent establishment as well as to structured arrangements. In addition, ATAD requirements on hybrid mismatches with so-called reverse hybrid entities (Art. 9a ATAD) are transposed by creating a new non-resident tax status.

The new provisions will be applicable **for the first time** to expenses arising **after 31 December 2019**. Expenses, however, which have been legally caused already before 1 January 2020 will only be subject to the new provision under certain additional conditions.

For reverse hybrid mismatches, the catalogue of domestic income (non-resident tax liability) has been expanded: Accordingly, income from a majority interest in a domestic partnership is also subject to limited tax liability insofar as this income is not subject to taxation in the partner's country of domicile due to tax treatment of the partnership that deviates from German law (i.e. treatment as a non-transparent entity in the other state/country), does not already fall under another item of the catalogue of income

(e.g. income of permanent establishments) and is not subject to taxation in any other state/country. The provision will be effective for income accruing after 31 December 2021.

Overview of other amendments

Extension of the tax return filing date: The filing date for assessment period 2020 will be extended by three months (i.e. for taxpayers using a tax advisor until 31 May 2022 and for taxpayers not using a tax advisor until 31 October 2021) and the interest-free grace period will be extended by three months to 18 months.

Outlook

The next step is the act to be promulgated in the Federal Law Gazette. The act will enter into force on the day after its promulgation. The specific provisions governing the application dates of individual laws are to be observed.

Act to Modernise the Relief from Withholding Tax promulgated

The Act to Modernise the Relief from Withholding Tax and the Certification of Capital Gains Tax [AbzStEntModG] was promulgated in the Federal Law Gazette (BGBl. I 2021, p. 1259) on 8 June 2021.

The key points of this Act are:

- Revision of the anti-treaty shopping rule
- Amendments to the provisions governing the relief procedure for foreign taxpayers from withholding tax
- Amendments to the provisions on the arm's length principle under the Foreign Tax Act

Relief from withholding taxes

The Act revises the provisions applicable for relief from withholding taxes owing to double taxation agreements and EU directives. In particular, this applies to withholding tax reductions for dividends and royalties that can either be claimed by way of an exemption procedure or a refund.

Treaty/directive shopping

The anti-abuse rules undergo substantial revision. Most of the amendments represent a significant tightening of rules. In essence, however, it remains the case that no withholding tax reduction is granted if a company with little obvious function is interposed between the shareholder and the distributing or paying domestic company.

For **personal entitlement to relief**, the shareholder needs to have an entitlement to relief under the 'same entitlement provision'. This would not be the case even if the shareholder were to be entitled to claim the equivalent amount of relief but this entitlement resulted from another DTA. In comparison with the current version, this represents a significant tightening of rules. In the case of so-called 'meander structures' (with domestic shareholders of the foreign entity), the personal entitlement to relief does not apply under the revised version. This, however, does not yet lead to a refusal of the withholding tax reduction. The next step is to examine the material entitlement to relief of the foreign entity.

For **material entitlement to relief**, a 'material nexus' (link) of the income from the shareholding (or the licensing right) to the economic activity of the foreign entity is henceforth required. The currently applicable anti-

treaty/directive shopping rule, however, is based on the 'gross income from own economic activity' of the foreign entity. To that extent, this also represents a tightening of rules.

The anti-treaty/directive shopping rule is not applicable if it can be shown that **none of the main purposes** for the interposition of the foreign entity constitutes a **tax advantage**. The interposition of the foreign company is only considered abusive if there are no economic or other valid reasons for this.

Further tightening is provided for the exception in the form of the stock exchange clause which, according to the explanatory memorandum, is henceforth only applicable to the foreign entity. The listing of a shareholder on a stock exchange, however, does not suffice.

According to the special rule for first-time application, the amended version of the anti-treaty/directive shopping rule applies to all open cases. To avoid inadmissible retroactive effect in those cases in which the new version would leave the taxpayer in a worse position, a procedure for assessing the most favourable tax treatment is intended, insofar as the capital gains or remuneration was received prior to the new version entering into force – i.e. up to and including 8 June 2021.

Rules of procedure

The procedure for relief of withholding tax on capital gains and withholding tax is laid down in the newly established § 50c Income Tax Act [EStG], and the respective provisions of § 50d EStG currently in force are withdrawn. In this regard, there are several amendments.

A key amendment is the legal basis to wholly process online both the exemption and refund procedure is established. Pursuant to the timeline of the provision's application, the online procedure is first applicable to applications filed after 31 December 2022.

Transfer pricing

With the new act, extensive revisions are made to the provisions governing transfer pricing. The wording of the provisions on the adjustment of income (§ 1 Foreign Tax Act) is revised extensively and, thereby, shall be closer aligned to the **OECD transfer pricing guidelines**. The existing hierarchy of methods with the primacy of the standard methods (comparable uncontrolled price method, resale method and cost plus method) is dropped. The "most suitable method" must be applied instead.

In order to determine the arm's length price, first of all 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. The principle of substance over form must come to the fore.

Separate provisions on transfer pricing in the event of the transfer or licensing of intangible assets are new as well. The concept of an intangible asset is legally defined, in close alignment with the OECD transfer pricing guidelines, for the first time. The proprietor or owner of the intangible asset must compensate related persons adequately if and in so far as they perform services or exercise functions in relation to the intangible asset (in connection with the development or creation, the enhancement, the maintenance, the protection, or any kind of exploitation of the

intangible asset; so-called "DEMPE" concept: Development, Enhancement, Maintenance, Protection, and Exploitation).

The already existing provisions regarding so-called **price-adjustment clauses** for cases where substantial intangible assets constitute the subject matter of a business relationship are laid down separately and extended in a new § 1a Foreign Tax Act. The period for potential price adjustments, among others, is reduced from ten to seven years following the conclusion of a transaction.

The provisions governing the arm's length principle are applicable to income and corporation tax for tax assessment period 2022 first.

Federal Tax Court (I R 2/18): Abusive Tax Arrangements when Merging a "Profit Company" into a "Loss Company"

In its judgment of 17 November 2020, the German Federal Tax Court [BFH] ruled that, under 2008 legislation, merging a "profit company" into a "loss company" and the latter offsetting the positive income of the "profit company" applicable to the retroactive period against its own losses does not constitute an abuse of tax planning options.

Pursuant to § 42 of the German Tax Code [AO], tax legislation cannot be circumvented by abusing legal options for tax planning. Where the element of an individual tax law's provision to prevent circumventions of tax has been fulfilled, the legal consequences shall be determined pursuant to that provision. Where this is not the case, the tax claim shall in the event of an abuse arise in the same manner as it arises through

the use of legal options appropriate to the economic transactions concerned.

The plaintiff (GmbH A, a German limited liability company) had liquidity problems at the end of 2008. It was facing insolvency. The usual sources of liquidity such as capital injections by shareholders or bank loans were not an option to boost liquidity. GmbH A acquired all shares in GmbH D. GmbH D was subsequently merged into GmbH A with retroactive effect. The loss due to the merger was not recognised for tax purposes. However, GmbH D's positive income applicable to the retroactive period was offset against the plaintiff's loss carryforwards. This led to the release of GmbH D's tax provisions. After deduction of the purchase price, the plaintiff received liquid assets because the assets were no longer displaced by provisions.

The dispute between the parties was whether the merger of a profit-making company into a loss-making company constitutes an abuse of tax planning options within the meaning of § 42 AO as applicable in the year under dispute (2008).

The BFH ruled that the wording of § 42 AO leaves no doubt that provisions of individual tax laws supersede the application of § 42 AO only when the elements of these provisions are relevant. Based on these standards, taking the income generated by GmbH D during the retroactive period into account in the plaintiff's taxation in accordance with legislation as applicable in the year under dispute (2008) is not an abuse of law. At that time, there was no circumvention prevention provision in an individual tax law that would have prevented the acquisition of shares and the

merger of a profit-making company. Furthermore, there is no abuse of law, as the arrangement to be assessed in this case is not unreasonable. The taxable entity is fundamentally permitted to arrange its affairs such that no or as little tax as possible is incurred and, in doing so, freely apply civil law arrangements provided for by law. A legal arrangement is only unreasonable when the taxable entity does not apply the arrangement provided for by the legislator to achieve a particular economic objective, but instead chooses an unusual venue by which the objective should not be achievable in the legislator's judgment. An arrangement that does not have any discernible economic purpose at all cannot be taken as a basis for taxation. Arrangements aimed at enabling the taxable entity to use a loss it generated itself have not been judged as an abuse of law in numerous judgments by the highest courts. In principle, it is not necessary to justify the offsetting of "genuine" business losses by other non-tax motives.

In 2013, the legislator created a provision under individual tax law preventing the offsetting of positive income generated by the transferring entity during the retroactive period against loss carryforwards of the acquiring legal entity.

Tax Court of Hesse (6 K 1163/17): Intercorporate Dividend Relief in the case of Multiple Acquisitions of Shares in a Corporation during the year

The acquisition of a share is considered to have taken place at the beginning of the calendar year for tax purposes if a share of at least 10% was reached at any point during the calendar year. This is the judgment of the Tax Court of Hesse.

Distributions (dividends) by a German limited liability company [GmbH] to another GmbH are generally tax-exempt. By contrast, 5% of the distribution is considered non-deductible business expenses, so that 95% of the distribution must be excluded from taxation as a result. However, this only applies if the direct investment at the beginning of the calendar year amounts to at least 10%. Investments (participating interests) via a partnership must be attributed to the partner on a proportional basis and are considered a direct investment.

The suit was brought by a limited partnership with a limited liability company as general partner [GmbH & Co KG], whose business purpose is the holding and administration of all shares in the limited liability company 'GmbH M'. The plaintiff had concluded a profit and loss transfer agreement with this GmbH, based on which a tax group was established. Individual companies also held partnership interests in the plaintiff itself. In the year under dispute, several of its founding partners sold part of their limited partnership interests in the plaintiff to new partners. In this context, GmbH C acquired a total share of about 13% (brokered via partial limited partners' shares of about 5%, 2% and 6% each). In its assessment return for the year under dispute, the plaintiff treated the part of a so-called 'additional transfer from prior to the tax pooling (Mehrabführung aus vororganschaftlicher Zeit)' attributable to GmbH C as a tax-exempt distribution.

In dispute was whether GmbH C benefits from so-called intercorporate dividend relief as a result of multiple acquisition of a share of at least 10%. The tax office upheld the known view of the tax authorities that

participating interests acquired from various sellers during the year below the investment threshold of 10% on an individual basis do not lead to tax relief. This is also not changed by the fact that the acquisitions occurred on a contractual basis. However, this is disputed in the literature.

The deciding senate agreed with the opposing opinion and ruled in favour of the plaintiff. The term "investment" used by the legislator, in the sense generally understood in business dealings, mainly serves to determine the ideal sum of the shareholder's rights under company law in the capital and profit of the corporation and is exhaustively expressed in this figure by providing the corresponding percentage. Therefore, the "acquisition" of such an investment (participating interest) includes all transactions under civil law that contributed to creation of the participating interest in the course of the calendar year. From this perspective, the acquisition of the participating interests from three sellers totalling about 13% has a retroactive effect on the beginning of the year under dispute (2014), which is why the investment is included in tax exemption. This notwithstanding, the outcome would be identical also when applying the narrower view taken in the literature of at least considering "block acquisitions", as GmbH C acquired its investment based on a single decision and by implementing an overall plan in this respect by means of a single legal transaction under the law of obligations.

This judgment is not yet final. An appeal is pending before the German Federal Tax Court under file number I R 16/21.

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