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BMF draft guidance on the application of the rules on hybrid mismatch arrangements (anti-hybrids rules)

The Federal Ministry of Finance (BMF) has published a draft of a BMF guidance on the prohibition of deduction of expenses in the case of taxation mismatches due to hybrid mismatch arrangements (section 4k Income Tax Act – ITA) under the date of 13 July 2023. The associations will be given until 10 August 2023 to comment on this draft.

In the following, the rules on hybrid mismatch arrangements (section 4k ITA – anti-hybrids rules) and its background are briefly described and the essential contents of the BMF draft guidance are summarised.

1. Background

The anti-hybrids rules in Section 4k ITA are based on the EU Anti-Tax Avoidance Directive (ATAD) and was introduced by the ATAD Implementation Act of 25 June 2021. The anti-hybrids rules are generally to be applied for the first time to expenses incurred after 31 December 2019.

The aim of the anti-hybrids rules is to neutralise taxation mismatches in connection with hybrid mismatches arrangements. To this end, section 4k ITA contains successive prohibitions on the deduction of business expenses (section 4k (1) to (5) ITA), which are to be applied irrespective of a DTA and other existing rules on the prohibition of deduction of expenses. The scope of application is limited to (contractual) arrangements between related persons within the meaning of section 1 para. 2 Foreign Transactions Tax Act – FTTA, between a company and its permanent establishment as well as to structured arrangements (section 4k (6) ITA, no participation relationship required). Payments affected by the anti-hybrids rules must be stated separately in the tax return.

Tax mismatches caused by hybrid mismatch arrangements in cross-border situations can be based on different hybrid elements: on the different legal classification between two countries (conflict of qualification) of financial instruments, legal entities (companies, also permanent establishments) and transfers. This can result in a tax deduction in both states (double deduction - DD) or a deduction in one state with simultaneous non-taxation in the other state (deduction/non-inclusion - D/NI).

Content

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2. Essential content of the draft guidance

Overview

The BMF draft guidance contains 128 paragraphs on 52 pages. The core of the guidance is the explanations on the taxation mismatches rules in section 4k (1) to (5) ITA and the resulting prohibitions on deducting operating expenses (marginal no. 19 to 116). Also of practical relevance are, among other things, the marginal numbers on the existence of a so-called structured arrangement within the meaning of section 4k para. 6 ITA (marginal no. 10 and 11), on the taxpayer's duty to cooperate (marginal no. 120, 121) and on the relationship of the anti-hybrids rules to other business expense deduction prohibitions (marginal no. 124 to 128).

Temporal application (marginal no. 3 to 6)

The anti-hybrids rules are applicable for the first time to expenses incurred after 31 December 2019. Expenses that were already legally incurred before 1 January 2020 are only deemed to have been incurred after 31 December 2019 if they are based on a continuing obligation and could have been avoided without significant disadvantages as of that date.

If there is no continuing obligation, the anti-hybrids rules are not to be applied even if expenses are incurred after 31 December 2019. In this context, the (clarifying) statements according to which deductions for depreciation are not based on a continuing obligation, and this is also to apply to interest carry forwards within the meaning of the interest limitation rule that only have a tax effect from 1 January 2020 (carryforward of exceeding borrowing costs) and therefore section 4k ITA is not to be applied in either case are particularly important for practice (marginal no. 3).

Furthermore, the BMF draft guidance addresses the requirement of "avoidance of expenses without significant disadvantages" in the case of continuing obligations (marginal no. 5). In particular, a termination should be associated with significant disadvantages if the resulting costs (e.g. prepayment penalty) exceed the tax advantage from the tax mismatch.

Personal scope of application (marginal no. 7 et seqq.)

The scope of application is generally limited to (contractual) arrangements between related persons within the meaning of section 1 (2) FTTA or between a company and its permanent establishment (section 4k (6) sentence 1, variants 1 and 2 ITA).

If there is a structured arrangement, however, the anti-hybrids rules are also applicable to situations between third parties (section 4k (6) sentence 1, variant 3 ITA). This fact leads to application problems in practice. According to the first variant of section 4k (6) sentence 3 ITA, a structured arrangement is to be assumed if the tax advantage was fully or partially included in the terms of the contractual agreements. According to the draft guidance, this can take place, for example, in the form that an additional payment or a higher payment is agreed than would have been or will be agreed under comparable conditions without taxation inconsistency. A case of structured arrangement also exists, for example, if a remuneration adjustment is subject to the condition precedent of the realisation of a tax advantage from a hybrid mismatch arrangement. In particular, when hybrid financial instruments are used, the tax advantage accruing to the creditor can also be passed on to the debtor via lower interest rates than those that are customary for third parties.

Furthermore, a structured arrangement pursuant to the second variant of section 4k (6) sentence 3 ITA exists if the terms of the contractual agreements or the circumstances underlying the contractual agreements indicate that the parties involved in the arrangement could expect the tax advantage. In this regard, the BMF clarifies that it is irrelevant in this respect whether the taxpayer actually has knowledge of the creation of the tax advantage or his participation in a structured arrangement.

Taxation mismatch: Hybrid financial instruments (section 4k (1) ITA) (margin no. 19 to 36)

Section 4k (1) sentence 1 ITA provides for a prohibition of deduction for expenses which, due to the use of a hybrid financial instrument ("divergent tax qualification"), lead to a non-taxation or low taxation of the corresponding income abroad (D/NI mismatch) because of the different classification of the financial instrument on the part of the remuneration debtor and the remuneration recipient as equity or debt or in the case of hybrid transfers ("divergent allocation"). Hybrid financial instruments could be, in particular, convertible bonds, hybrid loans, silent participations, profit-sharing rights and participating loans. An attribution of beneficial ownership of capital assets that deviates from German tax law could lead to a hybrid transfer, e.g. in the context of securities lending or so-called repo transactions (marginal no. 19).

The term “expenses” for the use of capital assets (in particular interest and comparable payments for the borrowing of capital assets) is not to be limited to payments, but is to include all reductions in income across periods (marginal no. 21).

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Example: hybrid financial instruments (marginal no. 24): X-corporation (State of domicile = Germany) issues a convertible bond at a price of 5,000 to its foreign parent company M Co. As a result, X regularly makes payments of 100 to M Co, each of which is to be qualified as interest expense in Germany. At M Co, on the other hand, the corresponding income is regarded as investment income of X (conflict of qualification) and tax exempt. The expenses of X are not deductible as business expenses according to section 4k (1) sentence 1 ITA in the amount of 100 each, since the income corresponding to the interest expense is not taxed at M Co.

Of practical relevance is the clarifying statement on the "causality" of the hybrid element for the prohibition of deduction of operating expenses, according to which the anti-hybrids rules are not to be applied if, in addition to the qualification or attribution mismatch, other causes outside the scope of the anti-hybrids rules arise for a non-taxation or low taxation of the income corresponding to the expenses (e.g. personal tax exemption of the creditor) (marginal no. 26). If various hybrid elements are causal for the taxation mismatch, this must be eliminated in accordance with the order of the paragraphs of section 4k ITA (marginal no. 26).

“Non-taxation" is said to exist insofar as the income corresponding to the expenses is not included in a tax assessment basis (including CFC taxation). The actual inclusion is decisive. Taxation at a tax rate of zero per cent (insofar as the other requirements of section 4k para. 1 ITA are met), the factual tax exemption of the income corresponding to the expenses as well as the (proportional) waiver of the levying of a foreign tax is defined as non-taxation. Taxation in a specific country, e.g. in the country of the direct creditor of the income corresponding to the expenses, is not necessary. Actual taxation of the income corresponding to the expenses in another country or by a legal entity not directly involved in the transaction is also sufficient in principle. Consequently, in the case of partnerships as direct beneficiaries of the income, the taxation of the partners of the partnership must also be examined. (marginal no. 27). A domestic withholding tax deduction is sufficient (no non-taxation), provided the withholding tax is not refunded in full (definitive burden (marginal no. 29).

“Lower taxation" is said to exist if the income is subject to a lower effective tax burden abroad than that which would result if the capital assets were qualified or attributed in accordance with German law. The extent of the lower taxation is the result of the difference between the actual taxation of the income abroad and the hypothetical taxation of the income abroad in the case of a qualification or attribution of the capital assets corresponding to German law. The German level of taxation of corresponding income should not be relevant as a standard of comparison (marginal no. 30).

Taxation mismatch: Deviating tax treatment of the taxpayer (section 4k para. 2 ITA) (marginal no. 37 to 60)

Section 4k (2) sentence 1 ITA provides for a prohibition of deduction for expenses in the case of deviating tax treatment of a taxpayer (legal entity) and for fictitious expenses in the case of deviating tax assessment of debt relationships to be assumed between a company and its permanent establishment (section 1 (4) sentence 1, no. 2 FTTA), insofar as D/NI incongruities arise from this.

According to the draft guidance, the concept of expenses within the meaning of section 4k (2) sentence 1 ITA includes expenses of all kinds and is not limited to payments, but includes all income changes across periods. Expenses in this sense are, for example, interest, royalties, rental fees and service fees as well as, in the case of economic goods, expenses for acquisition or production (e.g. purchase price), depreciation amounts and the write-off of the book value, e.g. in the case of sale (marginal no. 38, 39).

In particular, expenses of taxpayers who are regarded as non-transparent for tax purposes in Germany and who are regarded as transparent entities abroad (hybrid entities), which can also be the case if they are included in a foreign group taxation system, are covered by the provision (marginal no. 42). The draft guidance also explicitly mentions the "check-the-box procedure" that frequently occurs in practice with US inbound structures (marginal no. 43).

Example (based on marginal no. 50): A German corporation pays annual interest of 400 to its US-based parent company. It considers the interest payments as operating expenses. The corresponding income is not subject to taxation in the US because the German corporation is seen as fiscally transparent for US tax purposes and the service relationship between the German corporation and its parent is therefore not recognised. The operating expenses of the German corporation are therefore not deductible in the amount of 400 according to section 4k para. 2 sentence 1 ITA.

According to the draft guidance, a "causality" between the non-taxation and the hybridity is also required for this taxation mismatch. An existing conflict of qualification should not be exclusively causal for the non-taxation of the income, insofar as the income would not have been taxed abroad, e.g. due

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to its lack of taxability, factual tax exemption or the personal tax exemption of the creditor (marginal no. 48).

Pursuant to section 4k (2) sentence 3 ITA, sentence 1 does not apply if the expenses are demonstrably offset by income from the same taxpayer that is taken into account twice. The same taxpayer is the one to whom the deduction prohibition of section 4k (2) sentence 1 ITA applies. It is important to note that the taxpayer's income, which is taken into account twice, does not have to have any economic connection with the expenses covered by section 4k (2) sentence 1 ITA (marginal no. 53). However, "double counting" of income covered by section 4k (2) sentence 3 ITA presupposes that the income is subject to actual taxation both for the taxpayer in Germany and in the country of the creditor. Insofar as the double-counted income exceeds the harmful expenses in a taxation period, this income can be taken into account in a previous taxation period (retroactive event). However, it should not be possible to carry forward "unused" income.

Taxation mismatch: Different allocation or attribution of income (section 4k (3) ITA) (marginal no. 61 to 70)

Section 4k (3) ITA provides for a prohibition of deduction for expenses insofar as the income corresponding to the expenses is not subject to actual taxation in any country due to their tax allocation or attribution deviating from German law (D/NI mismatch). The draft guidance clarifies that section 4k (3) ITA covers in particular expenses to so-called reverse hybrid entities (marginal no. 61). As a rule, these are fiscally transparent in their country of domicile, while they are considered non-transparent for tax purposes in the country of their (indirect) shareholders (marginal no. 15).

Example (based on marginal no. 63): The domestic D corporation pays interest in the amount of 100 to its foreign parent company A Co. Since State A regards A Co as a transparent company (without a permanent establishment in State A) and State B (the State of domicile of the shareholder of A Co, which does not know any CFC taxation) regards A Co as a non-transparent company, the interest payment to A Co is not actually subject to taxation in any State.

Taxation mismatch: double deduction of expenses (section 4k (4) ITA) (marginal no. 71 to 90)

Section 4k (4) ITA neutralises taxation mismatches resulting from the double deduction of expenses (DD mismatches). The draft guidance explains that section 4k (4) ITA, in contrast to paragraphs 1 to 3, does not require a hybrid element. The draft guidance does not contain an example of Section 4k (4) ITA.

Expenses which are in principle deductible abroad, but which are not actually deductible, e.g. because of the application of other deduction prohibitions, are not to be considered as taken into account abroad (marginal no. 74). On the other hand, the increase of a loss that is in principle compensable for tax purposes or the consideration of expenses in the context of CFC taxation should also be (harmful) consideration within the meaning of the regulation.

With a view to the application of foreign group taxation systems, the draft states that, irrespective of the technique used - i.e. offsetting of income or full consolidation - expenses may be taken into account twice (marginal no. 75).

Finally, the draft guidance contains explanations on the exception from the prohibition of deduction (sentence 4) for persons with unlimited tax liability with income to which the tax credit or deduction method applies (e.g. foreign permanent establishment income) - no prohibition of deduction insofar as both expenses and income are taken into account twice (marginal no. 87ff.). However, the prohibition of deduction remains applicable insofar as these expenses also reduce (other) foreign income that is not subject to domestic taxation (re-exception). According to the BMF, income of other legal entities as well as any other foreign country must also be taken into account. Foreign group taxation systems are mentioned as an example of the re-exception. The entry into a foreign loss carry-forward of a permanent establishment is not harmful in itself, but at the time of the actual utilisation of the loss it must be examined whether income is reduced that is not subject to domestic taxation.

Taxation mismatch: Imported mismatches (section 4k (5) ITA) (marginal no. 91 to 116)

The prohibition of deduction under section 4k (5) ITA concerns taxation mismatches in which Germany is not directly involved, but which are shifted to Germany via one or more transactions (so-called imported mismatches). The regulation is to be applied subordinate to the other deduction prohibitions (paragraphs 1 to 4). The tax mismatches covered occur between other countries that do not eliminate them (marginal no. 91).

Example (marginal no. 95): The domestic D corporation pays interest in the amount of 100 to its foreign parent corporation A Co. The resulting interest income of A Co in the amount of 100 is subject to taxation in State A. A Co, in turn, makes payments of 50 on the basis of a hybrid financial instrument to its parent company B Co, which is resident in the foreign state B. The expenses of A Co are deductible in state A as interest. State B,

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on the other hand, qualifies the income of B Co as a tax-exempt profit distribution. State A and State B do not eliminate the resulting tax mismatch. The deduction of the expenses of A Co in the amount of 50 would have to be denied in State A if section 4k (1) ITA were applied accordingly, because the income of B Co (income resulting indirectly from the expenses of D corporation) is not taxed. The taxation mismatch is imported to Germany via the chain of relationships of the companies, so that the prohibition of deduction for the expenses of D corporation according to section 4k (5) sentence 1 ITA is applied to this extent (maximum 50).

The draft guidance states that in the case of multi-level business relationships, there must be a chain of relationships between the German taxpayer and the legal entity bearing the harmful expenses, but not a uniform economic connection between the respective expenses. The economic reason for the expenses does not have to be maintained throughout the entire supply chain, e.g. interest expenses on the one hand and licence expenses on the other (marginal no. 97).

According to the draft guidance, the examination of the regulation on imported mismatches is extensive. Under certain circumstances, it must be examined across the entire shareholding structure whether the prohibitions on deducting operating expenses in paragraphs 1 to 4, or if their conditions are not met, also the regulation in paragraph 5, would hypothetically have to be applied. The effects of a hypothetical application of the paragraphs - including the respective exemptions and the grandfathering provision in the temporal application - must be examined in isolation in accordance with the legal assessment of the respective foreign country (marginal no. 103f.).

If the tax advantage is also imported into another state, e.g. in the case of different service chains via different legal entities, the prohibition of deduction of operating expenses for imported mismatches is in principle applicable in Germany and the other country in parallel. In order to avoid an excessive prohibition of deduction, however, the deduction in Germany should only be denied on a pro rata basis (marginal no. 115f.).

Obligation to provide evidence and to cooperate (marginal no. 117 to 123)

The general principles shall apply to the distribution of the burden of proof: Burden of proof on the tax administration for tax-increasing facts (especially the existence of the conditions of paragraphs 1 to 5) and on the taxpayer for tax-reducing facts (especially for all exemptions and the grandfathering provision) (marginal no. 117, 119, 122). In addition, the taxpayer is subject to increased obligations to cooperate and provide evidence for foreign matters (marginal no. 120). Documents from the accounting of the legal entities involved, information from the foreign tax authorities (on the individual case) as well as the submission of foreign tax assessment notices, tax rulings or confirmations of the (non-)exercise of a foreign option may be required (marginal no. 121).

Relationship to other regulations (marginal no. 124 to 128)

In practice, the question often arises as to the relationship between the anti-hybrids rules and other business expense deduction prohibitions. If one of the relevant business expense deduction prohibitions is more extensive than another, the business expense deduction is excluded to the extent of the legal consequence of the more extensive deduction prohibition. A deduction prohibition is more extensive if it excludes the business expenses from deduction to a greater extent than other deduction prohibitions that are generally applicable. Definitive deduction prohibitions are also more far-reaching than temporary deduction prohibitions (marginal no. 124).

Therefore, the prohibition of deductions according to section 4k ITA, for example, always has priority over the interest limitation rules (section 4h ITA), as the latter only provides for a temporary prohibition of deduction of operating expenses.

3. Outlook

The associations have until 10 August 2023 to comment on the draft. The publication of a final version of the application decree is therefore not expected before September 2023.

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