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German Tax and Legal News

ATAD-implementation law: Draft law includes long-awaited reform of CFC rules

On 10 December 2019, Germany's federal Ministry of Finance published a draft law that would implement the EU anti-tax avoidance directive (including provisions of ATAD I and ATAD II), into domestic law. The draft includes a long-awaited reform of Germany's controlled foreign corporation (CFC) rules and other significant tax-related changes. The Ministry of Finance gave the tax associations (organizations that represent the interests of business and industry on tax matters) the opportunity to comment on the draft law until 13 December 2019. According to the draft law, the new CFC rules would be applicable for financial years of intermediary companies (companies that do not have a place of management or registered office in Germany) beginning after 31 December 2019.

The changes would affect various aspects of the CFC rules, including the definition of "control" and the list of activities that are considered active (non-passive), and have the potential to significantly increase the number of taxpayers that fall within the scope of the CFC regime (including in some EU/European Economic Area (EEA) situations). It is particularly noteworthy that the current minimum threshold of 25%, below which "low taxation" is considered to exist would be maintained, and that there are some provisions that differ from the provisions of ATAD I.

Background

Under Germany's existing CFC rules, passive income of intermediary companies derived from low- or no-tax jurisdictions is attributed to German resident taxpayers that control together, directly or indirectly, more than 50% of the subsidiary (lower ownership percentages apply where the low-taxed intermediary generates passive investment income). There is a list of activities that are considered to generate active income; all other types of income are considered passive income.

A jurisdiction is regarded as a low-tax jurisdiction if the income of the intermediary company is subject to an effective tax rate of less than 25%. However, the relevant income must be re-calculated applying only German income tax law (and disregarding foreign rules for the determination of income).

The low-taxed passive income of an intermediary company is attributed proportionally to the resident taxpayers and taxed in Germany as though the income was directly earned by these shareholders. The attributed income is included in the taxpayer's taxable income for the tax period to which the first day after the end of the intermediary company's financial year belongs. Taxes paid on the attributed income or on the property underlying the income by or on behalf of the intermediary company are deductible from attributed income, or may on application be credited against the German income tax or corporate income tax charged on attributed income, in the year of payment.

The attributed income (less any taxes deducted from the income for income tax or corporate income tax purposes) also is subject to the German municipal trade tax, which typically ranges between 14% and 17%. (The corporate income tax rate is 15 % (15.825%, including the solidarity surcharge) and the effective corporate tax rate, including the solidarity surcharge and trade tax, typically ranges between 30% and 33%.)

The CFC rules do not apply to EU/EEA-resident intermediary companies when the taxpayer can demonstrate that the foreign company carries out genuine economic activities, i.e. that it meets a "substance test."

No lowering of the threshold for low taxation

German politicians have discussed lowering the threshold for low taxation to 15%, although a previous draft law dated 28 December 2018 (“tram draft”) did not propose a reduced threshold for low taxation. No reduction of the 25% threshold is included in the new draft law published on 10 December 2019, nor are there measures to permit a tax credit against the trade tax. This systematically would lead to excessive taxation where foreign income is taxed at an effective rate of more than 15% (the German statutory corporate income tax rate) but less than 25% because the foreign tax burden would be supplemented by the additional German trade tax that could not be offset by a tax credit. The trade tax could exceed 15% (depending on the assessment rate) and effective burdens of 40% and more could result.

Concept of control and legal consequences

In accordance with ATAD I, the existing concept of control under the domestic law would be abandoned and replaced by a new concept of control. Under the current rules, control over a foreign company is considered to exist if German residents hold more than 50% of the shares in the foreign company, regardless of whether the German residents are related. Under the draft law, control over a foreign company would exist only if more than 50% of the shares, voting rights, capital or entitlement to profits of the foreign company are directly or indirectly attributable to a resident taxpayer and its related parties. “Related parties” would be defined as in the existing CFC rules, but also would include persons acting in "cooperation," as defined in the draft law. A person would be deemed to be related to the relevant taxpayer if that person cooperates with the taxpayer in relation to the intermediate company through concerted conduct. In the case of direct or indirect partners in a partnership or co-entrepreneurship that hold a direct or indirect shareholding in an intermediate company, cooperation would be presumed to exist; however, this presumption could be rebutted.

Another change would be that domestic control could exist even in the case of limited tax liability if the participation is attributable to a German permanent establishment (under the existing CFC rules, only resident taxpayers with unlimited tax liability are attributed income from a foreign company). In addition, the existing provisions relating to passive income of an investment nature (which allow the attribution of income to a resident taxpayer that holds a stake of at least 1% (or potentially less) in a foreign company, under certain circumstances) would move to a new section of the relevant legislation that would be applicable outside of the concept of control.

As noted above, the concept of control under the draft law would apply to both direct and indirect participations, which would make a provision of the existing CFC rules superfluous that requires income of an intermediary company’s foreign subsidiary to be proportionally attributed to the intermediary company under certain circumstances. Under the draft rules, the income of an intermediary company’s foreign subsidiary would be attributed to the intermediary company’s domestic controlling shareholder based on the shareholder’s indirect participation in the subsidiary’s nominal capital. An exception would apply only to the extent that additional taxation under German or comparable foreign law applies at the level of a company holding the participation that would lead to high taxation. Due to the retention of the low-taxation threshold of 25% under the draft rules, the CFC rules in countries that have a tax rate of less than 25% normally would not avoid additional taxation being levied in Germany.

Under the draft law, the additional income that is subject to tax under the CFC rules still would be considered as a dividend for which the exemption provisions would not apply. As under the current rules, the additional income also would have to be determined in accordance with the provisions of German tax law, with no provisions being explicitly excluded in the future, which would mean that limitations on the deductibility of interest and royalties (which are not taken into account when determining a CFC’s profit under the current rules) and a new provision prohibiting the deduction of operating expenses in the case of hybrid structures also would be applicable. Unlike the existing rules, the determination of the additional income by means of a revenue surplus calculation would be prohibited in the future. For the first valuation of assets, as well as for transfers of assets in the course of reorganizations, a kind of "book value continuation" would be ordered.

As prescribed by ATAD I, under the draft law, the additional income from the intermediary company would be attributed to the resident taxpayer on the last day of the intermediary company’s financial year, rather than on the first day after the end of the intermediary company’s financial year. This would lead to a double entry of an additional income amount in the assessment period for 2020, namely: (1) the additional income for the fiscal year ending on 31 December 2019, and (2) the additional income for the fiscal year ending on 31 December 2020 (assuming that the intermediary company’s fiscal year follows the calendar year).

To avoid double taxation, the draft law would permit the crediting of foreign taxes against income or corporation tax that is attributable to the additional income. The current option of deducting foreign taxes from the additional income no longer would apply. Upon application, foreign withholding tax levied at the level of companies holding the (indirect) participation also could be credited against German income or corporation tax. However, there is no provision for offsetting foreign tax against the German trade tax, which means that an existing flaw with the system would continue, since the additional income would continue to be subject to trade tax. This leads to the possibility of an excessive tax burden due to the interaction of foreign taxes and additional taxation under the CFC rules, described earlier.

Subsequent distributions by the intermediary company of previously taxed profits would be tax-exempt under the new concept of a "reduction amount for profit distributions" under the draft law. As a result, the existing exemption under the Income Tax Act no longer would be applicable and the crediting of foreign withholding taxes on profit distributions would be enabled in certain cases, as required by ATAD I.

Changes to list of activities generating active income

The draft law adheres to the conceptual design of the existing CFC rules and continues to provide a list of activities that are considered to generate active income. Types of income not covered by the list are considered passive income. This approach differs from that of ATAD I, which defines passive income.

However, the draft law surprisingly does not implement the proposals of the 2018 tram draft. It is noteworthy that the draft law:

- Would extend the concept of “harmful participation” that can cause income of trade and services companies to be considered passive income, to include cases where related parties resident in the EU/EEA participate in a transaction; and
- Would not extend the substance test (which permits income to avoid being classified as passive under certain conditions) to third country situations, and would introduce more specific requirements and tighten the test for EU/EEA situations. The "genuine economic activity" currently required would become an "essential economic activity," which would be further concretized by requiring the use of the necessary material and human resources (sufficiently qualified, independent and self-reliant personnel) in the relevant country in relation to the activity in question.

In detail, the draft law would result in the following significant changes to the current CFC rules.

Income from trade and provision of services

In general, income from trade and the provision of services would remain active income. However, under some circumstances, this would not be the case for income from trade/services that are carried out with/for the resident taxpayer or persons related to the resident taxpayer that are taxable in the EU or EEA on their income from the transaction. The legislature intends to introduce a new type of “harmfulness” relating to this kind of income—the harmful involvement of a related person resident in the EU/EEA. According to the explanatory memorandum for the draft law, this is to represent an implementation of the concept of an invoicing company in ATAD I and to provide for the implementation of an additional taxation mechanism in the EU/EEA. In effect, this represents an extension of the concept of passivity to the EU/EEA because, under the existing law, the concept of harmful involvement is limited to the resident shareholder of the foreign company or related persons that are subject to tax in Germany.

Intragroup purchasing and sales companies and intragroup service companies (e.g. intragroup contract research companies or shared service centers) would be considered to derive non-passive income only if they carry out business operations set up in a commercial manner and participate in general economic transactions. For service companies that "use" related persons in a harmful manner, it would not be possible to carry out business operations in a commercial manner.

Passive trading and service companies would be able avoid additional taxation only if the requirements of the substance test under the draft law (referenced above) are fulfilled. This test would remain applicable only in relation to the EU/EEA situations (and not in relation to third country situations, which had been proposed in the tram draft).

Income from licensing of rights

In principle, income from the licensing of rights would be considered passive. However, this would not be the case if results from the intermediary company’s own research and development activities that were developed without harmful participation are exploited. For this type of income, the concept of harmful participation would include involvement by a resident taxpayer or any related persons, regardless of whether the related persons are resident in the EU/EEA. It could be demonstrated that participation is "harmless" by fulfilling the substance test in accordance with the draft law. However, according to the draft law, this test would be applicable only in relation to EU/EEA situations (and not in relation to third country situations, which had been proposed in the tram draft).

Profit distributions

Contrary to ATAD I, which classifies dividends and income from the disposal of shares (covered below) as passive income, profit distributions generally would continue to be classified as active under the draft law, to comply with the provisions of the Corporation Tax Act (specifically, section 8b, which provides that dividends received by resident corporations generally are 95% tax exempt if the dividends are not tax-deductible expenses for the payer ("correspondence principle") and certain other conditions are fulfilled). However, this would not be the case if the profit distributions reduced the income of the distributing corporation, even if the profit distribution was made out of certain other types of active income listed in the CFC rules. Thus, the correspondence principle in the Corporation Tax Act also would be provided for in the CFC rules. A reverse exception would exist (under which dividends would be considered active income) for cases in which: (i) the distributing corporation itself is subject to additional taxation, or (ii) a hidden distribution of profits was subject to high taxation at a foreign intermediary company or a related person associated with the intermediary company. Thus, passive income that already was subject to additional tax when it arose would not be subject to additional tax again in the event of a distribution.

Distributions of profits in the case of widely held stock (for individuals and corporations) or where there is tax liability pursuant to section 8b (7) of the Corporation Tax Act on the part of the recipient would be classified as passive under the draft law, even in cases in which the distribution of profits was made out of certain other types of active income listed in the CFC rules. (Section 8b (7) provides that the 95% tax exemption for dividends does not apply to shares held in the trading portfolio of banks and financial service institutions.)

Capital gains

In general, capital gains from the disposal of a company's shares would be considered active income under the draft law. Capital gains would be presumed to be passive only in cases in which a corresponding capital gain would be taxable if the shares were disposed of by a German resident person pursuant to section 8b (7) of the Corporation Tax Act or a similar provision of the Income Tax Act that applies to individuals (section 3 (40)). In these cases, the draft law would provide for additional taxation if the capital gains are functionally attributable to an active activity of the foreign intermediary company.

Overall, however, the new rules would be an improvement on the situation under the current rules—the taxpayer no longer would have to demonstrate that a capital gain is not attributable to passive capital investment assets. Currently, taxpayers must prove that this is not the case even at an indirect level, which may require tracing assets through several levels of companies, down to the lowest investment level.

Reorganizations

Income from reorganizations still generally would be considered as active income under the draft law. The draft law, together with the explanatory memorandum, would clarify that reorganizations based on the transfer of assets that serve to generate certain other types of active income listed under the CFC rules generally would qualify as active without meeting further requirements (e.g. comparability of the foreign reorganization with a German reorganization). On the other hand, income from reorganizations in which passive assets generally are transferred would qualify as active only if the taxpayer proves that the foreign reorganization is comparable to a domestic reorganization and that the foreign conversion actually was carried out at book values. The draft law would require the actual book value of the assets according to foreign law to remain the same after the reorganization for income from the reorganization of a company with passive assets to be considered as active. There clearly would be practical difficulties in maintaining this proof.

Additional comments

The present draft law differs in significant part from the previous tram draft. It is welcome that, unlike under the tram draft, every intragroup trade or service activity would not be considered passive, with only a substance exception that also would have applied to third countries being able to prevent actual taxation. This would have led to a considerable amount of work as a result of the additional declarations that would have been required.

However, if the low-taxation threshold is not lowered from 25% during the legislative process, the scope of application of additional taxation will remain overly broad. The changes in the list of activities that are considered to generate active income, especially in the area of commercial and service activities, would further broaden the application of additional taxation.

The 25% threshold also would mean that, e.g. US subsidiaries potentially could be subject to additional taxation (given the current US statutory federal tax rate of 21%), depending on their state and local tax burden—without an option to avoid the application of the rules by demonstrating substance. In a February 2019 decision (Case C-135/17), the Court of Justice of the European Union recognized a violation of the free movement of capital under the Treaty on the Functioning of the European Union under Germany's currently applicable CFC rules in a third country situation, since additional taxation under the rules potentially could deter resident investors from investing in foreign companies. The decision possibly could serve as protection against the excessive scope of application of the rules in relation to the US. However, it is questionable whether this case law would continue to apply after the change to the new concept of control provided for under the draft rules.
