

ATAD implementation law: German Ministry of Finance issued first draft of anti-hybrid rules

The German Ministry of Finance issued a first draft of an "ATAD implementation law" ("ATAD-Umsetzungsgesetz") on December 10, 2019. The draft law includes inter alia the implementation of anti-hybrid rules as required by ATAD II, a major overhaul of the German CFC rules and an amendment of the German exit tax rules. From a TP perspective the draft law includes the implementation of the revised interpretation of the arm's length principle based on the OECD Transfer Pricing Guidelines 2017 and a legal framework for Advanced Pricing Agreements.

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The Ministry of Finance has asked for comments until December 13, 2019, the German government plans to finally adopt the draft on December 18, 2019 and as a next step to introduce it into the legislative process.

The following should be a first high level initial summary and provide some preliminary remarks in particular with regard to the implementation of an anti-hybrid rule into the German income tax code (new Section 4k ITC).

Sec. 4k (1) –(3) ITC includes provisions dealing with deduction/non-inclusion (D/NI) situations and reverse hybrid situations, Sec. 4k (4) ITC deals with double deduction (DD) situations and tax residency mismatches and Sec. 4k (5) ITC describes the rules for imported mismatch arrangements. Sec. 4k (6) includes a description of general criteria that are required for the application of the anti-hybrid rules like e.g. related persons, persons acting in concert and defines the term of a structured arrangement.

Effective date

Based on the draft law the following anti-hybrid rules should apply for payments/expenses that are triggered after December 31, 2019.

Deduction/non-inclusion provisions

Sec. 4k (1) ITC: Hybrid financial instrument and hybrid transfer mismatch rule

- Payments under a financial instrument or related to the transfer of a financial instrument
- Non-deductibility to the extent of a deduction without inclusion income
- Non-inclusion has to be the result of a qualification or allocation of the instrument different from the German qualification as interest
- Partial inclusion due to a difference in the qualification/preferential treatment seems to be captured as well
- Explanatory statement to the law explicitly mentions repo transactions that should be captured
- Denial of deduction should not apply to the extent the payment is included at the level of the recipient in a future period and the terms and conditions of the transaction are at arm's length

Also note that Sec. 8b(1)3 CITC includes a rule denying exemption for dividends received where a deduction arises at another person under a mismatch in allocation of the ownership of the respective shares (e.g. securities lending).

Observation: Sec. 4k (1) ITC seems to mostly follow the definition as provided in Art. 2 (9)

first subparagraph lit. a ATAD but does not specifically refer to the 12 month period as provided in Art. 2 (9) first subparagraph lit. a, second subparagraph ATAD.

Sec. 4k (2) ITC: Disregarded payments and deemed PE payments/internal dealings PE

- Payment by a hybrid entity being disregarded under the laws of the payee jurisdiction (e.g. German corporation checked as a DRE into the its US shareholder)
- Deemed payments between PEs being disregarded under the laws of the payee jurisdiction
- Sent. 1 refers to an actual non-taxation of the payment. Based on the explanatory statement the taxation of the payment as a result of the application of a CFC-like regime should be sufficient to avoid non-deduction.
- Payments captured by the rule are broadly defined in the explanatory statement (interest, royalties, rent, services or depreciation and fictitious expenses e.g. based on the ordinance on the allocation of profits of PE's)
- Contrary to para. 1 a denial of deduction should only apply in case of actual non-taxation
- The explanatory statement explicitly mentions payments from an entity which is treated as a intransparent entity in the country of its residence and as a transparent entity in the country of the payee.
- Sent. 2 refers to payments from a foreign corporate entity to its German shareholder where from a German tax perspective the foreign entity qualifies as a mere asset managing company and the payment is disregarded (should be mostly relevant from a German outbound perspective).
- Sent. 3 includes an exception from the denial of deduction in case of dual inclusion income. The exception however only applies in case of a double taxation is not avoided by means of the credit method.

Observations: The reference to a CFC-like regime as possibility to avoid a denial of deduction seems to be taxpayer friendly. It is questionable whether a taxation e.g. under US GILTI rules might be sufficient to avoid a denial of a deduction.

Payments by German corporations that are checked into the US to its US shareholder should create an issue under the rule. The exception in case of dual inclusion income is mainly based on the ATAD standard however limited in case the double taxation is avoided by means of applying the credit method.

Sec. 4k (3) ITC: Allocation mismatch, hybrid PE mismatches and disregarded PE's

- Applies to reverse hybrid entities as well
- Seems to be drafted as a "catch all" clause
- Applies in case the income related to the deductible expense is not being effectively taxed anywhere due to a mismatch of its allocation between German and foreign rules.

Observation: Even if not explicitly mentioned in the explanatory statement a taxation of the payment as a result of the application of a CFC-like regime should be sufficient to avoid a non-deduction. Sec. 4k (3) ITC should have a broad area of application and needs careful analysis in each structure.

Double deduction

Sec. 4k (4) ITC: Double deduction and tax residency mismatches

- A double deduction does not require a hybrid mismatch
- Explanatory statement includes an example with a checked German subsidiary that qualifies as a DRE/partnership from the view of its shareholder
- Sent. 3 includes an exception from the denial of deduction in case of dual inclusion income

Observations: The double deduction rule seems to be mostly in line with the requirements under ATAD II. Contrary to ATAD II there is no separate provision for tax residency mismatches, this provision is fully integrated into the double deduction rule. The double deduction rule might cause significant issues in US structures where German companies are checked into the US.

Imported mismatch rule

Sec. 4k (5) ITC: Imported mismatches

- Imported mismatch rule refers to expenses at the level of the direct payee or an

indirect payee that would be disallowed if the direct/indirect payee would be subject to German anti-hybrid rules

- Reference to a treatment under German domestic rules might create issues and deviates from the rules as required by ATAD
- Detailed rules regarding mechanism of primary/secondary response and collusion rules

Observations: Based on the wording the rule might affect IFL/notional interest deduction structures. The rule requires to carefully analyze (financing) structures above Germany and might lead to a significant increase of compliance work when preparing annual tax returns.

General definitions

Sec. 4k (6) ITC: Related persons, persons acting in concert and structured arrangements

- Sent. 1 highlights that the anti-hybrid rules as described above only apply in case of related party transactions, arrangements between a corporation and its PE or in case of a structured arrangement.
- Based on the definition of related parties a 25% ownership threshold for the application of the anti-hybrid rules is introduced. This goes beyond of what is required under ATAD (50% threshold in certain hybrid mismatch structures).
- Sent. 2 extends the application of the anti-hybrid rules to persons acting in concert
- Sent. 3 defines the term "structured arrangement" and seems to match the definition as provided in Art. 2 (11) ATAD.

Additional comments

The draft law to implement the anti-hybrid rules as required by ATAD into German domestic law mainly follows the minimum requirements as described in ATAD II. The draft law does not introduce a rate based minimum taxation at the level of the recipient of a payment in order to be tax deductible for German purposes. Payments with no hybrid features that benefit from a low taxation/no taxation at the level of a recipient due to general features of the tax regime should not be affected by the current version of the draft anti-hybrid rules. Preferential tax regimes – depending on its nature – could lead or may not lead to a denial of the deduction depending on the structure/details of the "preferential tax regime".

Irrespective of the above-described tax technical regulations, the German documentation requirements according to the General Tax Code will provide for substantial workload, e.g. the imported mismatch regulations (Sec. 4k (5) ITC) may require a disclosure of information about the tax position of the group by legal entity in order to avoid an assumed application of the imported mismatch rule.

The issuance of the first draft of the anti-hybrid rules shortly before the planned effective date is however unusual. A finalization of the legislative process still in 2019 should not be possible, it can be expected that the legislative process will be finalized at some point in 2020 and that the rules then enter in force with retroactive effect as of 01/01/20. Further changes in the legislative process cannot be excluded.

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