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German Tax and Legal News

Ministry of Finance issues draft decree on interpretation of anti-hybrid rules

On 13 July 2023, the German Ministry of Finance (MOF) published a long-awaited first draft of a decree on the interpretation of the German anti-hybrid rules, which are based on the EU anti-tax avoidance directive I and II (ATAD I and ATAD II) and were introduced on 25 June 2021 (with retroactive effect as from 1 January 2020). The draft decree (consisting of 52 pages with 18 examples) provides the view of the German tax authorities on the interpretation and application of the rules. Interested parties may provide comments on the draft decree until 10 August 2023.

The draft decree first explains that the German anti-hybrid rules were implemented based on articles 9 and 9b of ATAD II, which seems to highlight the intention of the German legislator to follow the rules as provided in the EU directive without going beyond what is required by such rules. From a timing perspective, the draft decree confirms that the anti-hybrid rules generally are applicable only to expenses that originate from hybrid transactions after 31 December 2019. Expenses incurred after 31 December 2019 that originate from hybrid transactions before this date should not be covered by the anti-hybrid rules (with an exception for continuing obligations, e.g., loan arrangements, which can fall under the rules under certain conditions). The draft decree also provides detailed guidance on the definition of a structured arrangement in terms of section 4k (6) of the Income Tax Code (ITC), where the non-deductibility of expenses can be triggered even in third party relationships (the anti-hybrid rules generally are applicable only to related party transactions).

With regard to the guidance provided in the draft decree on hybrid financial instruments (section 4k (1) ITC), deduction/non-inclusion situations (sections 4k (2) and (3) ITC), double deduction situations (section 4k (4) ITC), and imported mismatch situations (section 4k (5) ITC), the points set forth below should be highlighted.

Hybrid financial instruments
The draft decree provides the view of the tax authorities that section 4k (1) ITC applies to hybrid financial arrangements, such as convertible bonds, hybrid loans, typical silent partnerships, profit participation rights, and profit participating loans that result in a deduction/non-inclusion situation. The draft decree mentions, in particular, that repurchase agreement transactions should be covered by this provision. A partial non-inclusion is sufficient to fall under the rules of section 4k (1) ITC, as nontaxation as well as low taxation compared to the treatment of an instrument from a German perspective is sufficient. The draft decree provides that a hybrid mismatch in terms of section 4k (1) ITC can result from either a different qualification of the financial arrangement (e.g., difference in debt-equity treatment) or a different allocation of the financial arrangement (e.g., different allocation of beneficial ownership of a financial instrument).

The draft decree also includes guidance on the causal nexus that is required between the hybrid mismatch and the nontaxation/low taxation for purposes of section 4k (1) ITC. The draft decree further provides a definition of nontaxation that should be applicable to the anti-hybrid rules in general. The draft decree states that taxation within the scope of a foreign controlled foreign company (CFC) tax regime must be considered as taxation in terms of the anti-hybrid rules. Taxation of the respective income does not necessarily need to occur at the level of the direct recipient/creditor of the respective income; the taxation of such income at the level of another person that is resident in a different jurisdiction than the direct creditor also can be taken into account. Not only taxation that occurs at a foreign federal level but also taxation of the respective income that occurs at a foreign state or local level must be taken into account for the anti-hybrid rules. The draft decree also provides guidance on the definition of low taxation for purposes of section 4k (1) ITC and the income inclusion in future periods, which might be sufficient to avoid the application of section 4k (1) ITC.

Deduction/non-inclusions
Section 4k (2) ITC covers disregarded payments and deemed permanent establishment (PE) payments/internal dealings. The rule typically covers mismatches that are related to a German resident taxpayer. The draft decree confirms that the anti-hybrid rules are applicable on all forms of expenses and not limited only to payments. As a result, the anti-hybrid rules also cover amortization/deprecation expenses that result from hybrid transactions. The draft decree explicitly refers to US "check-the-box" elections and a potential deduction/non-inclusion situation that might result from such an election. With regard to dual-inclusion income (DII), the draft decree includes a confirmation that, in the case of a German tax consolidated group, the income of controlled subsidiaries might qualify as DII of the controlling parent entity. The draft decree also provides that it might be possible to carryback an excess of DII to previous periods to mitigate a deduction/non-inclusion situation in previous periods. A DII carryforward, however, is not possible. The tax authorities also confirm that the inclusion of DII must occur in the jurisdiction where the creditor is resident.

Section 4k (3) ITC covers deduction/non-inclusion situations that are not already covered by section 4k (2) ITC, e.g., allocation mismatches, reverse hybrids, hybrid PE mismatches, and disregarded PEs. The tax authorities in their guidance provide their view that nontaxation of income for foreign CFC rule purposes should be considered as well when determining if the conditions of a non-deductibility of German expenses are met. This approach might result in increased complexity as not only the reasons for the nontaxation at the level of the direct recipient of a payment from a German taxpayer would need to be considered but also at the level of other group companies that apply CFC rules. This, in particular, should be of relevance for structures of US-headquartered multinational enterprises.

Double deductions
Section 4k (4) ITC denies the deductibility of expenses for German tax purposes to the extent a deduction for these expenses also is available in another jurisdiction. Section 4k (4) ITC does not require a hybrid mismatch situation. The draft decree provides the view of the tax authorities that a deductibility of German expenses for purposes of a foreign CFC tax regime might result in a double deduction situation. In such a situation, the DII exception might be available to the extent German income also is being considered for purposes of the foreign CFC tax regime.

Imported mismatches
The imported mismatch rule of section 4k (5) ITC refers to expenses at the level of the direct recipient or an indirect recipient that would be disallowed if the direct/indirect recipient is subject to German anti-hybrid rules. The draft decree confirms that there does not need to be an economic link or an economic connection between the expenses in a chain. The draft decree provides an example where a German company is making rent payments to a related party and the related party is then making royalty payments to another group company where the royalty payments result in a hybrid mismatch. The draft decree confirms that, in such a situation, the imported mismatch rules can be triggered. The draft decree also confirms that, even in the case of a foreign related party that is part of a consolidation regime, the expenses of other companies that are part of the same consolidation regime must be considered for the imported mismatch analysis. Based on the view of the tax authorities, this also should apply in the case of transparent entities where expenses/income are allocated to the shareholder.

The draft decree confirms that the imported mismatch rule must be applied by hypothetically applying the anti-hybrid rules of sections 4k (1) to (4) ITC at the level of the respective foreign entity and provides for an ordering rule for such an analysis. If the imported mismatch rules are applied by several jurisdictions on the same indirect payment that results in a hybrid mismatch, the draft decree provides for a pro-rata limitation to avoid an excessive denial of business expenses. The application of such a pro-rata denial is explained in two examples in the draft decree.

The draft decree also provides for the presumption that if another EU company that is in the relevant chain that is analyzed for the imported mismatch situation, based on the EU-wide application of the minimum standard of ATAD II, the other EU jurisdiction would deny the deduction with regard to the hybrid mismatch. This presumption, however, should not be applicable: (i) where there is conflicting evidence or (ii) where the German anti-hybrid rules exceed the minimum standard of the anti-hybrid rules as provided by ATAD II. The draft decree in this regard mentions as an example the definition of a related party for purposes of the anti-hybrid rules, which for German tax purposes includes a 25% minimum shareholding, whereas article 9 ATAD II in connection with article 2 (4) subparagraph 3 ATAD

II provides for a 50% minimum shareholding.

Procedural aspects
In the final part of the draft decree, the German tax authorities provide their view on the burden of proof related to the application of the anti-hybrid rules. As the application of the anti-hybrid rules might result in a denial of the deductibility of expenses and, therefore, an increase of the taxable income of a taxpayer, the tax authorities have the burden of proof for the application of the rules. For purposes of the exceptions from the general rules, e.g., the DII, the burden of proof is with the taxpayer. The draft decree refers to the increased documentation obligations for taxpayers in this regard and the obligation to provide information about the tax treatment of group companies in foreign jurisdictions.

Comments
Since the introduction of the German anti-hybrid rules in 2021, additional guidance from the German tax authorities has been eagerly awaited by taxpayers and tax professionals. The anti-hybrid rules introduced a whole set of new concepts, legal terms, and definitions, and left a multitude of questions about the application in specific fact patterns unanswered. The mechanical application of the rules in various situations results in a denial of the deduction of expenses where, from an economical perspective, such a denial causes an unjustified additional tax burden and double taxation.

The publication of additional guidance by the MOF is highly welcome and should provide insight into the view of the tax authorities. The expectations by taxpayers and tax professionals on the issuance of such guidance, however, are not met by the draft guidance. The guidance generally applies a broad interpretation of the rules and does not take economic results into consideration. Guidance provided by other EU jurisdictions on the application of their domestic rules seems to be more advanced, takes economic considerations into account, and tries to mitigate unjustified outcomes of the anti-hybrid rules. The draft decree of the German tax authorities seems to apply a different approach and applies a very broad interpretation to ensure that every possible situation based on the wording of the rules is captured. Common issues that are seen in practice, e.g., the treatment of global intangible low-taxed income (GILTI), the treatment of disregarded cost-plus remuneration payments, the practical difficulties of the application of the imported mismatch rules, etc. are not addressed in the draft decree. It would be desirable if the MOF takes public comments into consideration and more closely follows the trend that can be seen in other EU jurisdictions.

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