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By PwC Deutschland | 24 March 2021

Government draft for the implementation of the Anti-Tax Avoidance Directive (ATAD Implementation Act) submitted

On 24 March 2021, a government draft bill aiming to implement the Anti-Tax Avoidance Directive (ATAD) passed the cabinet (in the following referred to as “Draft”) after lengthy political efforts.

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Previous efforts to implement the European Anti-Tax Avoidance Directive

On 10 December 2019, the German Ministry of Finance published an initial draft bill for the implementation of the ATAD. A second draft bill was published in September 2020 (dated 24 March 2020). There had also been efforts to include the ATAD rules in the 2020 Annual Tax Bill but such recommendations were not adopted. Finally, on 24 March 2021 the government draft bill passed the cabinet.

Under the Draft, the ATAD rules on hybrid mismatch arrangements shall be implemented and the existing German CFC and exit taxation rules shall be adjusted - inter alia - in light of ATAD.

The decisive aspects of the provisions included in the Draft are briefly described below.

Hybrid mismatch arrangements

Under Article 9 and 9b of the ATAD, EU member states are - inter alia - obliged to disallow the tax deductibility of expenses that arise from hybrid mismatch arrangements. The tax deductibility of expenses shall be denied (i) if the corresponding income is not effectively taxed (deduction / no inclusion; **D/NI-outcome**) or (ii) if the expenses are tax deductible in another jurisdiction (double deduction; **DD-outcome**). An exception may apply to the extent the taxpayer has so-called dual inclusion income (*i.e.,* income that is included in the ordinary income of two jurisdictions).

Furthermore, the tax deductibility of expenses shall be disallowed in case of an **imported hybrid mismatch**. An imported hybrid mismatch can arise, if a hybrid mismatch between two foreign jurisdictions is shifted (“imported”) into another jurisdiction via the use of a non-hybrid instrument (*e.g.,* normal loan).

The aforementioned shall be implemented into German law by the introduction of a new Section 4k ITA-draft. Section 4k ITA-draft is accompanied by amendments in other Sections of the German ITA and CITA that shall ensure an inclusion as ordinary income in case of hybrid mismatch arrangements (*e.g.,* by the disallowance of the application of the German domestic participation exemption).

Paragraphs 1 - 3 of Section 4k ITA-draft relate to D/NI-outcomes. DD-outcomes are covered by paragraph 4. Paragraph 5 deals with imported hybrid mismatches and paragraph 6 defines the scope of the rules to transactions between affiliates and so-called structuring arrangements. Paragraph 7 establishes a general “treaty override”.

Contrary to the previous draft from March 2020, the legislative materials of the Draft, inter alia, clarify that the inclusion of expenses for foreign CFC taxation purposes shall generally not give rise to a DD-outcome under Section 4k (4) ITA-draft, if the German entity is seen as being non-transparent.

The effective date of Sec. 4k ITA-draft is generally January 1, 2020 (*i.e.,* **retroactive application**). A grandfathering rule exempts certain expenses that were already legally incurred before 1 January 2020.

CFC-taxation

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As part of the implementation of Article 7 and 8 of the ATAD, the Draft provides for adjustments to the existing German CFC rules (Sections 7 et seq. FTA). In this respect, the following should particularly be noted:

Control

One key element of the proposed draft German CFC rules is the adjusted definition of the control-criterion. Currently, a foreign corporation is typically "controlled" if 50 percent or more of the shares in the foreign corporation are directly or indirectly held by German tax residents, regardless of whether the German tax residents are related or unrelated.

Under the proposed new German CFC rules, a foreign corporation is controlled, if more than 50 percent of the shares in the foreign corporation are directly or indirectly held by the German (indirect) shareholder and/or its affiliates, regardless of whether the affiliates are German or non-German tax residents.

Active Income

The so-called active income catalogue which defines all active income that is not subject to the German CFC rules remains in place. However, the definition of certain active income items is adjusted and restricted (*e.g.,* for income subject to the German domestic participation exemption and income from reorganizations).

With regard to income from trading and the provision of services, the currently applicable law shall – contrary to the preceding draft – remain unchanged.

Low taxation

The draft sticks to the 25% effective tax rate threshold. Therefore, several jurisdictions continue to fall within the scope of the German CFC rules. Based on the explanatory notes of the Draft, this is justified by the ongoing discussions at the OECD-level in relation to the implementation of a global minimum taxation.

Calculation of CFC-income

When calculating CFC-income, German Tax law needs to be applied, *e.g.*, also German anti-hybrid rules, the interest and royalty barrier rule and the domestic participation exemption.

Exit tax

Under Article 5 of the ATAD, EU member states are obliged to tax built-in gains, if an asset or a business is transferred to another jurisdiction (*i.e.,* exit taxation). The same holds true for a migration of a corporation to another jurisdiction.

Furthermore, the jurisdiction to which the asset or business is transferred or to which the corporation migrates, shall recognize the assets at the value that was used for purposes of other jurisdiction's exit taxation, provided such value equals the fair market value of the asset. As a result of this rule, the tax basis of the assets is stepped-up.

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The adjustments to the existing German exit taxation rules particularly include (i) a unification of the methods for a deferral of the tax payments and (ii) adjustment of the rules that result in a step-up of the German tax base in case the German taxation right is extended or established for the first time.

In addition, the Draft provides for adjustments of the exit taxation rules for individuals which - in particular - shall become more restrictive in EU cases. Among other adjustments, an indefinite deferral of the tax payment until the sale of the shares is no longer possible.

Outlook

The further legislative process needs to be closely monitored but it can be expected that the draft will be passed before the election in September.

Keywords

ATAD, International Tax