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New ministerial draft bill to implement the amendments to the EU Mutual Assistance Directive and further measures against base erosion and profit shifting

In early June 2016, the Federal Ministry of Finance (Bundesfinanzministerium; "BMF") published a ministerial draft bill on the implementation of changes to the EU Mutual Assistance Directive and further measures against base erosion and profit shifting (the "Ministerial Draft Bill", "MDB"). The most relevant changes are summarized below.

The planned legislation is, in particular, intended to implement Action Item 13 (enhancement of transparency) of the OECD BEPS-Project by introducing binding rules on "country-by-country reporting". Furthermore, the Ministerial Draft Bill provides for the implementation in national law of the planned amendments to the EU Mutual Assistance Directive regarding the exchange of tax rulings. Moreover, the Ministerial Draft Bill contains a legislative proposal to change section 8b (7) of the German Corporate Income Tax Act (*Körperschaftsteuergesetz*; "**KStG**"), which is relevant for credit institutions, financial services institutions and financial enterprises, and measures to strengthen the German taxation right in certain cross-border situations. Special emphasis should be placed on the planned amendments to the German Trade Tax Act (*Gewerbesteuergesetz*, "**GewStG**"), which are intended to ensure that CFC income attributed to German resident taxpayers pursuant to section 10 of the German Foreign Transactions Tax Act (*Außensteuergesetz*; "**AStG**") and certain passive income derived by a German resident taxpayer from a foreign fixed place of business or a foreign partnership become subject to trade tax in Germany. However, the Ministerial Draft Bill does not contain any proposals for the implementation of further Action Items of the OECD BEPS-Project, in particular of Action Item 2 (hybrid mismatch arrangements). Such provisions are currently being discussed at EU level in connection with the so-called Anti-BEPS Directive.

1. Amendments to domestic transfer pricing documentation requirements

The amendment of section 90 (3) of the General Tax Code (*Abgabenordnung*, "**AO**") is intended to implement Action Item 5 of the OECD BEPS-Project. With this proposal, the OECD intends to create more transparency regarding international corporate structures and intercompany value chains. Section 90 (3) AO MDB shall basically implement the OECD's Guidelines on so-called Local Files and Master Files.

The planned change of the documentation requirements applies, in particular, to companies generating a turnover of at least EUR 100 million that are part of a multi-national group of companies (non-German permanent establishments are sufficient for this purpose). These companies will have to prepare a so-called

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Master File, which is to provide an overview of the nature of the group's worldwide business activities and of the transfer pricing principles applied by the group. Based on this Master File, group companies also have to prepare a **Local File**. This Local File consists of a documentation of facts and an arm's length documentation. The documentation of facts shall describe the cross-border transactions with other group companies and the conditions and prices underlying such transactions. The arm's length documentation must contain information on the time when the transfer prices were determined and on the transfer pricing method applied. The new requirements on the contents of the documentation shall also apply to companies generating less than EUR 100 million turnover.

The documentation is generally to be submitted within a period of 60 days (or 30 days for extraordinary business transactions) upon request of the tax authority as part of a tax field audit. Only in exceptional cases, the tax authority may request submission of the documentation without a tax field audit. If the taxpayer fails to prepare the required documentation or if the documentation is so deficient as not usable, the tax authority has (pursuant to prevailing academic opinion) the right to estimate the bases of taxation. In such circumstance, statute rebuttably presumes that the taxable profits (income) stated in the German tax return are too low and, hence, are to be adjusted. Furthermore, fines may be imposed.

The new documentation requirements shall apply for the first time to fiscal years beginning after December 31, 2015.

2. Implementation of country-by-country reporting in national law

Pursuant to the Ministerial Draft Bill, German group parent companies generating consolidated sales revenues of at least EUR 750 million are subject to additional documentation requirements. According to the planned new section 138a AO MDB, they have to provide country-specific reports ("country-by-country reports") to the Federal Central Tax Office (*Bundeszentralamt für Steuern*; "**BZSt**") within one year from the end of each fiscal year, without this requiring a request by the tax authority. The BZSt will forward the reports by automated data transfer to all countries for which the country-specific reports contain information. The reports are forwarded to all countries that have entered into corresponding agreements with the BZSt. As far as is currently foreseeable, these countries will comprise the EU Member States and the signatories of the OECD Multilateral Competent Authority Agreement on the Exchange of CbC Reports. This confidential data, which is actually protected by the German tax secrecy, will be transferred without giving the taxpayer a prior hearing.

Section 138a AO MDB implements the country-by-country reporting developed by the OECD and the EU Commission in national law. Apart from a list of all non-German subsidiaries and permanent establishments, the report shall include country-specific information about the business performed by the German group through its non-German subsidiaries or permanent establishments. In this context, information is to be provided, including, without limitation, sales revenues, income tax paid during the fiscal year, equity capital, number of employees, and tangible assets. The reports are to be prepared in accordance with the officially prescribed data set. In deviation from the draft EU directive dated 12 April 2016, section 138a AO MDB does not provide for an obligation to publish the country-specific reports.

If a German group company is part of a non-German group of companies, the non-German group parent will submit country-by-country reports to the tax administration of its country of residence. The non-German tax administration will then forward the country-specific report for Germany to the BZSt. Therefore, the German subsidiary is generally not subject to a reporting requirement. There is an exception, however, if the BZSt does not receive the country-specific report for Germany from the country of residence of the non-German group parent. In this case, every German resident group company is obliged to transfer the relevant data to the extent that it holds or can procure such data (section 138a (4) AO MDB).

One special feature is the so-called surrogate filing, which shall be possible under section 138a (3) AO MDB for non-German groups of companies having subsidiaries in Germany. If the group parent instructs its German subsidiary to submit the country-specific report for Germany, this subsidiary is obliged under public law to transfer the data set. Since the group is free to instruct the German subsidiary accordingly, the provision is, in fact, an option. The BZSt transfers the data received from the German subsidiary to the respective non-German authorities. Ultimately, the German tax administration is ready to receive surrogate filings if a country-by-country reporting is not possible or not mandatory in the group parent's country of residence.

If a company subject to resident taxation in Germany fails to fulfill these obligations completely, partly or in due time, its management commits an administrative offense that is sanctioned with a fine not exceeding EUR 5,000.

The reporting requirements shall apply for the first time to fiscal years beginning after December 31, 2015. The report shall then be submitted no later than one year from the end of the respective fiscal year.

3. Automatic exchange of Tax Rulings

On December 8, the Council of the European Union extended the scope of application of the EU Mutual Assistance Directive (Directive 2011/16/EU). The supplement to the Directive provides for the automatic exchange of cross-border tax rulings and APAs on transfer prices between multinational companies ("Tax Rulings"). Tax Rulings in favor of individuals are excluded from the automatic exchange. The amendments to the Directive shall be implemented in national law by the present Ministerial Draft Bill.

The German authority in charge of the exchange is the BZSt. In this function, the BZSt will have to provide certain information on tax rulings issued, changed or renewed after December 31, 2016 to the respective authorities of the Member States ("Receiving Authority") and the Commission at predefined intervals. The Receiving Authorities, in turn, will be entitled to request additional information about the respective Tax Rulings, including the full wording of the Tax Rulings. The Commission, however, will be provided with a limited catalogue of information only. Additionally, the automatic exchange will also comprise any Tax Rulings that have been issued, made, amended or renewed from January 1, 2012. Regarding this retroactive exchange, exceptions are planned in favor of small and medium-sized enterprises.

The information to be exchanged must be submitted by the BZSt within three months from the end of the calendar year in which the Tax Rulings were issued, made, changed or renewed. Regarding the retroactive exchange, the information has to be provided before January 1, 2018. It is not necessary to hear the taxpayer before providing the information.

4. Trade tax treatment of CFC-income

By judgment of March 11, 2015, I R 10/14, the Federal Fiscal Court (*Bundesfinanzhof*; "**BFH**") decided - contrary to the position of the German tax administration - that CFC-income imputed to a German resident taxpayer pursuant to Section 10 AStG is not subject to trade tax in Germany. Hence, under the current rules, CFC-income is only subject to (corporate/personal) income tax. The Ministerial Draft Bill provides that the Trade Tax Act be amended such that CFC-income of German taxpayers will become subject to trade tax as from <u>January 1, 2017</u>. The trade tax rate is set by the local municipalities and on average amounts to 15%. The proposed amendment will thus increase the overall tax burden on CFC-income imputed to German corporations from currently 15.825% to approx. 31%.

5. Trade tax treatment of certain passive income derived from a foreign fixed place of business or from foreign partnerships

Under the currently applicable rules, income derived by German taxpayers through a foreign fixed place of business and/or a foreign partnership is fully exempt from trade tax in Germany. Accordingly, such income is only subject to (corporate/personal) income tax. With the Ministerial Draft Bill, the BMF intends to introduce provisions limiting the trade tax exemption. More precisely, certain <u>passive</u> income in terms of Section 20 (2) AStG derived by a German resident taxpayer through a foreign fixed place of business and/or a foreign partnership shall, as a general rule, no longer benefit from the trade tax exemption. This may, for instance, apply to income derived through a foreign fixed place of business or a foreign partnership from the licensing of acquired IP or IP researched and developed with the involvement of a German taxpayer. It is also noteworthy that the new rules are meant to apply irrespective of whether the passive income is subject to a double tax treaty exemption or whether the applicable double tax treaty operates the tax credit method. Hence, the new rules appear not to distinguish between foreign operations which constitute a permanent establishment of the German taxpayer under the applicable double tax treaty and foreign operations which do not. As a counter exception, however, the proposed rules provide that passive income shall nevertheless continue to benefit from the trade tax exemption, if the activities performed in the foreign fixed place of business and/or the foreign partnership stand up to the *Cadbury Schweppes* test. The amendment is planned to become effective as of <u>January 1, 2017</u> and will increase the overall tax burden on passive income derived by German corporations through a foreign fixed place of business or a foreign partnership from currently 15.825% to approx. 31%, unless the requirements of the *Cadbury Schweppes* Escape are met.

6. Trade tax treatment of dividends received by subsidiaries in a fiscal unity

Under the currently applicable rules, dividend income received by German corporations is generally 95% tax exempt for corporate income tax and trade tax purposes, subject to the fulfillment of certain minimum shareholding quota requirements. By judgment dated December 17, 2014, the BFH decided that, as an exception to the aforementioned rule, dividend income received by a controlled entity within a fiscal unity (*Organgesellschaft*) shall be fully exempt from trade tax in Germany if the head of the fiscal unity is a corporation or a commercial partnership in which only corporations hold participations. As a consequence, the trade tax treatment of dividend income received by controlled entities within a fiscal unity is currently more favorable than the trade tax treatment of dividend income received by corporate entities which are not included in a fiscal unity but taxed on a stand alone basis. This unequal treatment is inconsistent with the position of the German tax administration. With the Ministerial Draft Bill, the BMF intends to introduce new wording, which shall ultimately ensure that dividend income received by a controlled entity within a fiscal unity shall at maximum benefit from a 95% trade tax exemption. The amendment shall apply for the first time to dividends received by controlled entities within a Fiscal unity after December 31, 2016.

7. Modification to the interpretation of the arm's length principle

By introducing section 1(1) sentence 5 AStG MDB, the BMF intends to establish the rule that the application of the arm's length principle generally follows the provisions of section 1 AStG – irrespective of whether this corresponds to the Art. 9 OECD Model Convention equivalent in the applicable double tax treaty. The provision is intended to become the legal basis for a general treaty override in the field of transfer prices. Thus, the so-called "clairvoyant clause" (*Hellseherklausel*) pursuant to section 1 (1) sentence 3 AStG will, in the future, govern the application of the arm's length principle under German domestic tax law and under double tax treaty law. According to section 1 (1) sentence 3 AStG, it is to be assumed that the (German) taxpayer is aware of all price factors, including those from the sphere of the non-German business partner. In particular, the law assumes that the German taxpayer is aware of (higher) profit expectations of the (non-German) business partner at the time of the relocation of business functions and intangible assets. The non-German business partner's higher profit expectations, which are estimated for lack of determination, are, on their part, the reason for an upward adjustment of the transfer price for relocated functions and intangible assets under the German transfer of business functions taxation rules. On the other hand, according to the government's statement of motives, the amendment is also intended to make clear that the application of the arm's length principle of the double tax treaty might also lead to a tax reduction.

In addition, the BMF shall be authorized to issue a regulation on the interpretation of the arm's length principle with the consent of the Federal Council (*Bundesrat*). This regulation may include further treaty overrides. In this regard, it is also noteworthy that the Federal Constitutional Court (*Bundesverfassungsgericht*; "**BVerfG**") recently decided that treaty overrides are generally permissible under German constitutional law (decision 2 BvL 1/12 dated 15 December 2015).

The amendment is expected to enter into effect on the day following the announcement of the final law derived from the Ministerial Draft Bill.

8. Fallback of taxation right in certain cross-border situations

The double tax treaties entered into by Germany frequently provide for the application of the so-called exemption method in relation to certain income that is generated by a German resident taxpayer in the other state. As a consequence of the exemption method, the respective income is excluded from the German assessment basis of the resident taxpayer; however, it may be taken into account for purposes of determining the personal income tax rate of individuals.

Section 50d (9) of the German Income Tax Act (*Einkommensteuergesetz*; "**EStG**") is a unilateral provision introduced by the legislator to ensure that the application of the exemption method in double tax treaties does not lead to non-taxation (so called "white income") or low taxation of income derived by German resident taxpayers from a foreign state. According to this provision, the income shall not be exempt notwithstanding the provisions of the double tax treaty if the other state applies the provisions of the treaty in a way that the income is to be exempt from tax in that state or may only be subject to tax at a rate that is limited by the treaty, or if the income is not subject to tax in the other state only because it is generated by a person who is not subject to resident taxation in that state.

The German tax administration has held the view so far that the provisions of section 50d (9) EStG shall also be applicable if only part of the income is not subject to tax or subject to tax at a low rate in the other state. In contrast, the BFH took the legislator "at its word" in two recent appeal proceedings (I R 68/14 and I R 69/14) and refused to apply section 50d (9) EStG in these cases. With the planned revision of section 50d (9) EStG, the BMF intends to codify the tax administration's view by replacing the word "if" in section 50d (9) EStG by "to the extent". Furthermore, by introducing a new section 50d (9) sentence 4 EStG, the BMF intends to ensure that the "to-the-extent" perspective is also taken into account in the application of "subject-to-tax" clauses in double tax treaties, even if the wording of the treaty does not provide so.

The amendment is planned to become effective as of January 1, 2017.

9. New rules for the treatment of income from investments for credit institutions, financial services institutions and financial institutions

Dividends and capital gains are generally 95% tax-exempt in the case of corporations (section 8b KStG) and 40% tax-exempt in the case of natural persons (section 3 no. 40 EStG, so-called partial income method (*Teileinkünfteverfahren*)). On the other hand, current expenses and losses incurred with shareholdings in corporations are not or only partly tax deductible.

However, according to section 8b (7) KStG and section 3 no. 40 EStG, exceptions apply to credit institutions and financial services institutions if the respective shares are attributable to the trading book. In this case, dividends and capital gains are fully taxable and current expenses and losses incurred with shareholdings are fully tax deductible at the level of credit institutions and/or financial services institutions. This rule is intended to prevent tax distortions with regard to the set-off of profits and losses from stock trading and other financial instruments not covered by section 8b KStG at the level of banks. The legislator maintains this objective but, in the future, section 8b (7) KStG and section 3 no. 40 EStG will no longer refer to the "trading book" within the meaning of German supervisory law but to the "trading portfolio" in accordance with section 340e (3) of the German Commercial Code (*Handelsgesetzbuch*; "**HGB**"). The trading portfolio comprises all financial instruments that are neither attributable to the asset portfolio nor to the liquidity reserve. According to the government's statement of motives, the reference to the trading portfolio within the meaning of the HGB is intended to prevent structures that are aimed at achieving tax benefits. While supervisory law permits a rededication from the trading book to the so-called asset book, section 340e (3) HGB generally does not provide for a reclassification into and out of the trading portfolio.

Pursuant to section 8b (7) KStG and section 3 no. 40 EStG, corresponding provisions apply to so-called "financial enterprises" which have acquired shares within the meaning of section 8b KStG with the purpose of realizing proprietary trading gains in the short term. In the case of such enterprises, dividend income and capital gains as well as current expenses and losses connected to shares within the meaning of section 8b KStG are subject to full tax if the specified requirements are met. Pursuant to section 1 (3) German Banking Act (*Kreditwesengesetz*; "**KWG**"), financial enterprises are companies that are neither financial institutions nor capital management companies and that have, as their principal activity, the holding of participations and other financial instruments. According to case law of the BFH, the requirements for a financial enterprise can also be met by holding companies of a group. This provision, thus, warrants that not only a specific sector (credit institutions and financial services institutions), but generally all companies can benefit from the advantages of section 8b (7) KStG and/or section 3 no. 40 EStG (loss deduction) if they meet specific activity-related requirements. In future, however, section 8b (7) KStG and section 3 no. 40 EStG are intended to cover only those financial enterprises in which a financial institution or a financial services institution directly or indirectly holds more than 50% of the shares. Thus, it is questionable whether, due to the resulting restriction to a specific industry, section 8b (7) KStG (and maybe also paragraph (8)) as well as section 3 no. 40 EStG may acquire the character of a state aid inadmissible under EU law.

It is intended that the changes for credit institutions, financial services institutions and financial enterprises will apply for the first time to shares that will be recorded as addition to the business assets after December 31, 2016.

Outlook

The Ministerial Draft Bill of the BMF needs to be agreed within the Federal Cabinet. Thus, until the Federal Cabinet will pass its decision, the bill could be changed or supplemented. Draft acts resolved on by the Federal Government and introduced to the German Parliament are referred to as "Government Draft Bills". Following the introduction of the Government Draft Bill, the Federal Council and the Federal Parliament will have the opportunity to provide their comments. It is to be expected that the legislative procedure will be concluded in the second half of the year. At the moment, it is unclear whether additional rules on combating hybrid structures will be implemented in this legislative procedure or in a separate procedure. In the past, the Federal Council has repeatedly requested the German Government to propose measures for combating hybrid structures. It must be assumed that the

BMF intends to wait for the rules for combating hybrid structures (anti tax avoidance package) that are currently discussed at EU level.

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