

Changes in transfer pricing rules – 2020 Update

In March 2019, we provided an overview of the most important adopted and expected tax changes in German transfer pricing rules. We update this overview in this issue.

I. Current and future legal changes

1. Changes to the key German transfer pricing rule (Foreign Tax Act/ *Außensteuergesetz*): The draft bill of an EU ATAD Transposition Act (ATAD-*Umsetzungsgesetz*) by the German Federal Ministry of Finance (*Bundesministerium der Finanzen*) of December 10, 2019 includes proposed changes to Sec. 1 German Foreign Tax Act, in particular the introduction of a special regime for financing relations. The following key points of the draft bill are noteworthy:

- Introduction of the OECD principle of applying the most appropriate transfer pricing method
- Introduction of the DEMPE concept for the taxation of income from intangible assets
- Special regime for intra-group financing with a reversal of the burden of proof for the arm's length nature of interest rates
- Presumption for the qualification of brokered or passed-on loans as limited functions and risks services
- Mandatory transfer package valuation for transfers of functions without escape clauses
- New rules on price adjustments for intangible assets with a reduction of the observation period to seven years

The application of the ATAD Transposition Act was intended to start as from the assessment period 2020. The political implementation is currently uncertain. The cabinet consultation on the draft bill scheduled for December 2019 was rescheduled to 2020.

2. Changes of German CFC rules to implement the EU Anti-Tax Avoidance Directive („ATAD I - Directive“): The draft bill of an ATAD Transposition Act as of December 10, 2019 provides for the new CFC rules to be applied in any fiscal year beginning after December 31, 2019. The following key points of the draft bill are noteworthy:

- The requirement of control is defined with a focus on the shareholder and includes related parties.
- CFC-Losses can no longer be carried back, but only forward.



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- The threshold for low taxation of passive CFC income remains at 25%.
- Unlike EU ATAD which designates certain types of income as passive, German CFC rules keep treating all CFC income as passive unless it falls in certain boxes of active income. These boxes are partly modified.

The ATAD Transposition Act was supposed to apply for tax years beginning after December 31, 2019. The cabinet consultation on the draft bill scheduled for December 2019 was rescheduled to 2020. The implementation of the EU ATAD I - Directive into national law is still pending.

3. The extension of the ATAD I - Directive with additional rules on hybrid financing and hybrid structures („ATAD II - Directive“) entered into force on June 27, 2017: It must be implemented into national law by December 31, 2019, to be applied as from January 1, 2020; for reverse hybrids, the Directive must be implemented by December 31, 2021, to be applied as from January 1, 2022.

A first draft bill on the implementation of the directive was published on December 10, 2019 and proposes to exclude or restrict nearly all expense deductions if the (interest) income of the beneficiary is low taxed or not taxed. The ATAD Transposition Act was intended to apply for expenses incurred after December 31, 2019. The cabinet consultation on the draft bill was rescheduled to 2020. The implementation of the ATAD II - Directive into national law is still pending.

4. Changes to the EU Accounting Directive to introduce mandatory publication of income tax information for certain companies and branches („Public Country-by-Country Reporting“): The EU ministers of the Competitiveness Council (COMPET), which has been dealing with the matter so far, were unable to reach an agreement. Instead, the Economic and Fiscal Affairs Council (ECOFIN) continues the work. Since unanimity is required in the ECOFIN, a political agreement is unlikely.
5. Entry into force of selective amendments to double taxation agreements (DTAs) in transposing the OECD-BEPS recommendations as notified to the OECD on the basis of the Multilateral Instrument: The German Federal Ministry of Finance is expected to seek bilateral agreements with DTA states from 2020.

It is still remarkable

- that Germany, in its notification, has confirmed its long-standing view on the exemptions from the formation of permanent establishments through certain business activities. Accordingly, the preparatory and auxiliary activities listed in a DTA only avoid a permanent establishment if they actually prepare or support the main activity of the company in the individual case. Thus, the listed preparatory and auxiliary activities do not constitute "automatic" or *per se* exceptions to the definition of a permanent establishment.
- that Germany has refused to generally tax a commissionaire as a permanent establishment of the principal. However, Germany may agree to tax commissionaires as permanent establishments of the principal in bilateral double taxation agreements (as was already done in 2015 in the double taxation agreement with Australia with legal effect from October 11, 2016).

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- that Germany has indicated its willingness to introduce mutual agreement procedures with "guaranteed solutions" by means of arbitration.

6. Re-writing versus re-pricing of contracts: In several judgments since February 27, 2019 (ref. I R 73/16, I R 51/17 and I R 81/17), the I. Senate of the German Federal Fiscal Court (*Bundesfinanzhof*) has changed its prior case law. Previously, Art. 9 OECD-MC limited the scope of application of Sec. 1 Para. 1 German Foreign Tax Act to price adjustments. By revising its case law, the Senate authorizes corrections not only in amount (price adjustments) but also on grounds of principle, such as the neutralization of a profit-reducing derecognition or write-off of a receivable.

In addition, the Senate revises its case law on passive integration within the group. Considering the benefits of passive group integration in arm's length analysis may violate the arm's length principle.

Finally, the Senate interprets the ECJ decision "Hornbach"(C-382/16). Even if the taxpayer can prove economic reasons and the chosen structure does not qualify as purely artificial, a transfer price adjustment may still be required. Each case has to be analysed on its specific merits.

7. Cost Allocation Agreements: German administrative regulations (circular dated December 30, 1999) were already abolished by Federal Ministry of Finance circular dated July 5, 2018. The transition period for applying the previous regulations expired on December 31, 2019. As from January 1, 2020, the principles of Chapter VIII of the OECD Transfer Pricing Guidelines 2017 apply. Accordingly, companies' contributions to development and service under the cost allocation agreement are to be valued and remunerated at arm's length. Therefore, the cost-plus method is said to be no longer generally applicable.

8. Allocation of profits to permanent establishments (*Verwaltungsgrundsätze Betriebsstättengewinnaufteilung*): The German Federal Ministry of Finance has issued special profit allocation rules for unmanned permanent establishments (i.e. permanent establishments without personnel): The circular refers to certain paragraphs of the OECD Report on Permanent Establishments 2010. Accordingly, in the absence of attributable people functions the circular allocates only a small profit or no profit to unmanned permanent establishments, e.g. servers.

9. Reallocation of taxing rights and introduction of a global minimum taxation: In the course of the OECD/G20 BEPS Action item 1, the Inclusive Framework has published its Work Programme to adapt international tax law to the challenges of digitalization. The Work Programme significantly exceeds the digital economy. A fundamental redesign of international tax law is planned. The proposal comprises two pillars:

- Pillar One provides for a shift of taxing rights in favor of market states. According to the Unified Approach of the OECD Secretariat dated October 9, 2019, confirmed January 29/30, 2020, in country revenue above a (hitherto undefined) threshold shall establish taxing jurisdiction right for the market state, regardless of whether a physical presence exists. This new nexus is flanked by a three-stage profit allocation.

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- Pillar Two provides for a Global Anti-Base Erosion (GloBE) Proposal. By establishing a global minimum tax level and making it a pre-requisite of regular home country taxation, pillar two intends to eliminate incentives for tax competition.

Many questions are un-answered on both pillars. The OECD has proclaimed an ambitious pace: Until July 2020, political consensus is aspired. A final technical report shall be produced by the end of 2020.

The following table provides an overview of the changes, their content and time of application:

	Law or Rule affected	Content	Date of Application
1.	Key Transfer Pricing Rule	Draft bill to partially revise Sec. 1 German Foreign Tax Act	Government resolution on bill in 2020
2.	Controlled Foreign Companies Taxation	Draft bill to revise Sec. 7 et seq. German Foreign Tax Act to implement the ATAD I – Directive	Government resolution on bill in 2020
3.	Taxation of hybrids	Implementation of Sec. 4k German Income Tax Act, including rules on hybrid structures in order to implement the ATAD II – Directive	Government resolution on bill in 2020
4.	Public Country-by-Country Reporting	Implementation of Public Country-by-Country Reporting in EU Accounting Directive	Political agreement is unlikely
5.	Multilateral Instrument	Implementation of notified amendments to DTTs as a result of the OECD-BEPS recommendations through bilateral agreements	Ratification by Germany pending
6.	Transfer Price Adjustments under Article 9 OECD MC	Revision of Federal Fiscal Court judgements regarding barrier effects of Art. 9 OECD-MC regarding Sec. 1 German Foreign Tax Act as well as passive group integration benefits	All open tax cases
7.	Cost Allocation Agreements: Circular by the German Federal Ministry of Finance	Expiration of the transitional period; Chapter VIII of the OECD Transfer Pricing Guidelines is applicable for fiscal years beginning after December 31, 2019.	In force

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	Law or Rule affected	Content	Date of Application
8.	Allocation of Profits to Permanent Establishments: Circular by the German Federal Ministry of Finance	Introduction of number 6a for allocation of assets and profits to permanent establishments without people functions	In force
9.	OECD/G20 BEPS Action Item 1	Reallocation of taxing rights in favour of market stats (Pillar One) and implementation of a global minimum taxation (Pillar Two)	Final Report expected in 2020

II. Legal changes already implemented

Since our March 2019 overview, the following measures have been implemented:

1. Introduction of an obligation for taxpayers or tax intermediaries (usually tax advisors) to report cross-border tax arrangements and of an EU-wide exchange of information on the national tax arrangements: Application of the national implementing legislation from July 1, 2020. Mandatory disclosure shall apply to cross-border arrangements implemented after June 24, 2018.

The reporting obligation for purely domestic tax arrangements, which was still part of the draft bill, was not further pursued. However, it is to be expected that the extension of the reporting obligation to purely domestic cases will be put back on the political agenda.

2. Binding dispute resolution procedures in cases of double taxation within the EU in implementation of the EU Directive on the Settlement of Double Taxation Disputes: The directive was implemented into national law by the German EU Double Taxation Agreement Dispute Resolution Act (*EU-Doppelbesteuerungsabkommen-Streitbeilegungsgesetz*). It shall be applied to all dispute resolution appeals filed after July 1, 2019, which concern disputes relating to double taxation of profits realized in tax years starting on or after January 1, 2018.
 - The dispute resolution procedure is based on the EU Arbitration Convention and extends its scope of application beyond transfer pricing disputes.
 - The dispute resolution procedure is particularly important for disputes concerning the existence of permanent establishments.
3. German Act for the Transitional Period following the Exit of the United Kingdom of Great Britain and Northern Ireland from the European Union (*Brexit-Übergangsgesetz*): The United Kingdom's membership of the EU ended on January 31, 2020. According to the withdrawal agreement, EU law will be applicable between the EU and the United Kingdom for a transitional period. During the transitional period, the United Kingdom is, in principle, to be treated as an EU Member State under federal law. This also applies to tax law. The law entered into force when the withdrawal agreement entered into force.
4. German Act on Tax Arrangements to Accompany the Withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union (*Brexit-Steuerbegleitgesetz*): At the moment of withdrawal from the EU, the United Kingdom became a non-member state.

This could lead to gain realization under tax provisions. In particular

- a company could lose its tax residence in an EU or EEA country and be deemed liquidated, its goodwill taxed accordingly (Sec. 12 Para. 3 German Corporate Income Tax Act, *Körperschaftsteuergesetz*)
- an asset transferred at book value to a permanent establishment in the United Kingdom would be deemed extracted and the (remaining) hidden reserves as of the time of transfer would be taxed (Sec. 4g Para. 2 German Income Tax Act, *Einkommensteuergesetz*).
- taxes on hidden reserves in shares deemed realized by shareholders moving to the United Kingdom, but not levied so far, could be levied immediately (Sec. 6 Para. 5 Sent. 4 German Foreign Tax Act).

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The law provides for the avoidance of taxation of such profit realizations. In particular, compensatory tax book items recording the goodwill of an asset as of the time of its transfer to the United Kingdom can continue to be amortized over the remaining useful life of the asset, at the maximum over five years.

The provisions are also implemented in the case of a "Hard Brexit". The provisions entered into force on March 29, 2019.

5. German Act on the Fiscal Promotion of Research and Development (*Forschungszulagengesetz*): The legislator wants to promote research and development (R&D) by means of a research subsidy. In particular, the wages of employees who carry out R&D activities are eligible. The tax-free research subsidy amounts to 25% of the assessment base. The assessment base is limited to EUR 2 million. It is offset against the income or corporate income tax liability. If the research subsidy exceeds the tax liability, the excess part is paid out. Thus, in loss years, the subsidy can result in a 100% refund. The research subsidy is only granted upon application. The research subsidy can only be granted for R&D projects whose work is commenced after January 1, 2020. The eligible expenses must be received by the employee after December 31, 2019.

The table below provides an overview of all regulations in question, their content and date of application:

	Law or Rule affected	Content	Date of Application
1.	EU Directive on Automatic Information Exchange	Intermediaries or taxpayers must notify cross-border tax arrangements; Member States must exchange information on notified tax arrangements within the EU	In force; obligation to apply as of July 1, 2020; Applicable for tax arrangements implemented after June 24, 2018
2.	EU Directive on the Settlement of Double Taxation Disputes	Implementation of binding dispute resolution mechanisms for double taxation disputes within the EU	In force; Applicable for dispute resolution applications as of July 1, 2019 for double taxation of profits from tax years starting in or after January 1, 2018
3.	German Act for the Transitional Period following the exit of the United Kingdom of Great Britain and Northern Ireland from the European Union	Implementation of transitional regulations regarding treatment of the UK as a member state of the EU for the transitional period	In force; Applicable for the transitional period

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	Law or Rule affected	Content	Date of Application
4.	German Act on Tax Arrangements to Accompany the Withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union	Implementation of transitional regulations accompanying Brexit, including regulations on the continuation of book values	In force; Applicable in case of a "Hard Brexit" as well
5.	German Act on the Fiscal Promotion of Research and Development	Implementation of a tax-free research subsidy	In force; Applicable for expenses occurred after December 31, 2019

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