International Tax

Germany Tax Alert

7 November 2014

Upper house of parliament proposes new anti-hybrid rule and other measures

Contacts

Stefan Grube
sgrube@deloitte.de

Axel Kroniger
akroniger@deloitte.de

Alexander Linn
allinn@deloitte.de

Andreas Maywald
anmaywald@deloitte.com

On 7 November 2014, Germany's upper house of parliament (*Bundesrat*) approved a draft tax bill that includes a new anti-hybrid rule and several other measures (*Law on the adaptation of the General Tax Code to the European customs codex and amendment of other tax provisions*). The draft is part of a legislative process initiated by the federal government in September, although the version approved by the upper house includes several new measures.

The most important proposed changes are the following:

- In response to the OECD base erosion and profit shifting (BEPS) initiative, a deduction for business expenses would be disallowed to the extent there is no corresponding income inclusion (deduction/no-inclusion) or to the extent there is a reduction of the taxable income in another country for the same expenses (double deduction).
- A 10% minimum shareholding requirement would be introduced to qualify for the 95% participation exemption on gains from a sale of shares.
- The intragroup restructuring exception would be broadened for purposes of the change-in-ownership rule.
- The triggering events for application of the real estate transfer tax (RETT) where the real estate is held by a partnership would be "clarified" on a retroactive basis.
- The boot consideration (i.e. non-share consideration) allowed under the Reorganization Tax Code for tax-neutral contributions in kind would be limited.
- Competency for certain withholding tax reclaims based on EU law would be centralized in the Federal Tax Office.

The amendments are based on the recommendations of the finance committee of the upper house. The federal government now will have an opportunity to comment on the proposed amendments and to determine whether they will be included in the legislative process. The final vote on the draft tax law is expected in mid-December. Although it is unclear whether the changes proposed by the upper house will be included in the final version of the draft law and whether this will take place before year end, the changes do reflect the current political environment in Germany and it is likely that at least some of the proposals will make it into the final version.

Details of proposed changes

Anti-hybrid and anti-double-dip rule: The proposed anti-hybrid rule would disallow a deduction of business expenses for German tax purposes in two situations:

1) To the extent the corresponding income is not included for tax purposes at the level of the direct or indirect recipient of the payment; or
2) To the extent the income is treated as being tax exempt at the level of the recipient.

In both cases, the noninclusion would have to be based on a mismatch relating to the underlying debt instrument, e.g. in the case of a hybrid instrument that qualifies as debt at the level of the German borrower and as equity at the level of the foreign recipient.

In addition, a proposed “anti-double-dip rule” would disallow a deduction for German tax purposes to the extent there is a deduction for tax purposes for the same expenses in another jurisdiction.

The proposed rules would become effective for the fiscal year in which they are formally published. Should the law including this provision be enacted in 2014, the rule could become retroactively effective for 2014.

The proposals are based on the OECD BEPS Action Item 2 (hybrid mismatches), as described in the report published in March 2014. Interestingly, in its tax policy statement issued in November 2013, the German federal government took the position that unilateral measures resulting from the BEPS initiative should be taken only if no consensus could be reached at an international level after the final publication of the relevant OECD reports in 2015. Whether the government will revise this position during the legislative process remains to be seen.

It should be noted that the proposals of the upper house would not be limited to related party transactions, but also would encompass transactions with unrelated third parties. This goes beyond the OECD recommendations and it is questionable whether (and how) a taxpayer would have to demonstrate how the income in a third party transaction is treated at the level of the foreign recipient for local tax purposes. The introduction of the term “indirect recipient” raises even more questions. Based on the official explanations, the inclusion of indirect recipients should target back-to-back structures. It appears that this terminology (which previously has not been used in German tax law) is based on the deduction/no-inclusion outcome as described in Action Item 2 of the BEPS initiative.

Based on the wording of the anti-hybrid rule and the reference to Action Item 2 in the official explanations to the draft law, it is possible that the rule also would apply where the noninclusion at the level of the recipient is based on the fact that the underlying debt instrument is ignored for tax purposes by the country where the recipient is resident. This would target structures in which the payer is a subsidiary of the recipient and treated as a disregarded entity in the country of the recipient. As a result, the debt instrument would be ignored for purposes of the taxation of the recipient, which, under the new rules, would potentially result in the expenses on the instrument being nondeductible for German tax purposes.

With respect to anti-double-dip structures, the proposal specifically mentions structures involving German partnerships where, under the German tax accounting rules for partnerships, interest expenses may be deductible for German tax purposes at the level of the partnership and for foreign tax purposes at the level of the relevant partner at the same time. The proposal aims at shutting down these frequently used structures in the future.

Capital gains from the sale of portfolio shareholdings would no longer qualify for the 95% participation exemption: The introduction of a 10% minimum shareholding for the application of the 95% tax exemption for capital gains from the sale of shares responds to the law change after the Court of Justice of the European Union ruled that Germany's withholding tax on outbound dividends violates EU law. As a result, a 10% minimum shareholding requirement for the application of the 95% participation exemption for dividends was introduced in 2013. Based on the official explanations provided by the upper house, the proposed law change would shut down tax planning opportunities resulting from the currently different treatment of capital gains and dividends. The upper house previously launched several initiatives to introduce the same treatment, but thus far has been unsuccessful.

Broadening of the intragroup restructuring exception to the change-in-ownership rules: Under the change-in-ownership rules, net operating loss carryforwards, interest carryforwards and current year losses are forfeited if there is a "harmful change in ownership." The intragroup restructuring exception introduced in 2010 provides relief from loss forfeiture; under this rule, a harmful change in ownership will be deemed not to take place if there is a sole (100%) direct or indirect shareholder in both the transferring and the receiving entity.

Based on the wording of the existing rule and the interpretation of the tax authorities, the intragroup restructuring exemption does not apply where the ultimate parent company is involved in a transaction, since the ultimate parent typically has more than one shareholder (e.g. in the case of a listed company).

The proposal of the upper house would extend the intragroup restructuring exception to transfers where the 100% ultimate shareholder is involved and also would broaden the application of the rule to transactions where the ultimate shareholder that is involved in a transaction is a partnership or an individual.

The amended rule would apply retroactively to share transfers that took place after 31 December 2009.

RETT rules for real estate held by partnerships: RETT is triggered if 95% or more of the interest in a real estate-owning partnership is transferred directly or indirectly to new partners within a five-year period. In such a case, the real estate-owning partnership is deemed to have transferred the real estate to a fictitious new partnership.

In a decision earlier in 2014, the federal tax court (BFH) held that an "economic" approach should be used to determine whether there has been an indirect change in the ownership of a real estate-owning partnership, under which both partnerships and corporations should be treated as transparent. The BFH went a step further by holding that only a 100% direct or indirect change in ownership of the direct partners in the real estate-owning partnership would qualify as an indirect change in ownership under the applicable provisions of the RETT Act (introduction of an "ultimate ownership test").

The amendment proposed by the upper house would retroactively codify the position of the tax authorities and abolish the approach of the BFH. According to the tax authorities and the wording of the amendment, separate tests would apply for corporate partners and for partnerships that are a partner of the real estate-owning partnership. For a corporate partner, an indirect ownership transfer would be deemed to occur if at least 95% of the shares in the corporation are transferred directly or indirectly to a new shareholder. For a partnership that is a partner, a harmful ownership transfer would be deemed to occur based on the partner's pro rata indirect interest in the real estate-owning partnership.

The amendment would apply retroactively as from 1 January 2002.

Reorganizations with "boot": The proposal includes a limitation regarding boot (i.e. nonshare consideration such as cash or loan receivables) that a receiving entity provides to the transferor in certain tax-neutral reorganizations. The amendment would limit the boot to 10% of the book value of the contributed assets in a tax-neutral reorganization. Any excess of the boot would make the transaction a taxable event.

The rule would apply to transactions taking place after 31 December 2014.

Federal Tax Office to determine withholding tax reclaims based on EU law: For a number of years, many foreign corporate shareholders and investment funds have filed reclaims for withholding tax on dividends paid by German companies where an argument could be made that the withholding tax was levied in violation of EU law, namely the free movement of capital provisions. With the exception of EU-resident corporate shareholders, the competency for dealing with these reclaims has been unclear. According to German case law, the tax office where the most valuable part of the German assets of the claimant is situated is competent to address such reclaims. However, particularly in cases where the claimant owns more than one shareholding in German companies, it often is very difficult to determine the competent tax office, resulting in complex reclaim procedures where parallel reclaims are filed with many tax offices.

The proposal of the upper house includes an amendment to the technical provisions of the law on tax administration that would significantly affect these withholding tax reclaims. Under the revised rule, the Federal Tax Office would be designated as the single competent tax office to address withholding tax reclaims of foreign corporate shareholders, regardless of the reason for the reclaims. Hence, the process would become significantly less burdensome for taxpayers and the tax administration.

Comments

The draft law approved by the upper house of parliament includes significant changes for foreign investors, especially investors from the US. The introduction of the anti-hybrid rule and the anti-double-dip rule would exceed the recommendations of the OECD and would have a broad scope of application. The broadening of the intragroup restructuring exception for purposes of the change-in-ownership rules would be a welcome step that should help to ease intragroup restructurings. Although the outcome of the proposals is still unclear, taxpayers should closely monitor the progress of the bill and any subsequent developments to avoid surprises.