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*German Tax and Legal News*

## Potential impact of EU anti-tax avoidance directive on domestic German tax law

The EU ATAD is expected to have an impact on German tax law, even if Germany seems to have delivered on the blueprint for several measures

The European Council reached an agreement on the draft anti-tax avoidance directive (ATAD), following a "silence procedure" that expired on 20 June 2016 without any EU member state raising objections. The directive will now come into force on the 20th day after its publication in the official journal of the EU, with most measures required to be implemented into the domestic law of the member states and applied as from 1 January 2019 (with certain exceptions).

The final ATAD provides for the minimum harmonization of rules in the areas of interest deductions, controlled foreign corporations (CFCs) and hybrid mismatches, and the introduction of a corporate general anti-abuse rule (GAAR). In addition, exit taxation rules must be introduced by the member states. Because (according to Art. 3 of the ATAD) the directive sets only a minimum level of protection, member states may introduce or retain rules that are stricter than the rules prescribed by the ATAD (subject to compatibility with primary EU law, such as the fundamental freedoms).

Even if German tax law seems to have delivered on the blueprint for several of the measures described in the ATAD, domestic rules will be significantly affected by the ATAD. The most notable points are described below:

**Interest deduction limitation rules (Article 4 ATAD)**
Germany introduced interest deduction limitation rules based on a 30% EBITDA limitation in 2008. The rules described in the ATAD, for the most part, reflect the German rules (de minimis threshold of EUR 3 million, asset-based group ratio calculation, unlimited interest carryforward and five-year carryforward of EBITDA). The directive, however, introduces a second group ratio test that is income based. This group ratio test takes into account the net third-party interest expense and the EBITDA at a group level, and applies this ratio to the EBITDA of the relevant taxpayer. This test does not exist under current German tax law. However, since the directive sets only a minimum level of protection, this test will not need to be introduced by Germany as an additional "escape clause" from the general 30% EBITDA limitation.

**Exit taxation rules (Article 5 ATAD)**
Germany has exit tax rules covering all four situations in which member states will be required to levy exit tax that are described in article 5(1) of the ATAD. Technical amendments could be introduced to align those rules because, e.g. in the case of a transfer of a corporate residence to a non-EU/EEA country, Germany's current rules provide for an exit tax, irrespective of whether Germany retains the right to tax the assets. In such a scenario, the ATAD requires an exit tax to be levied only on assets that no longer are connected to a permanent establishment that remains in the member state.

Additionally, current German tax law provides for the possibility of deferral of the payment of exit tax by booking a deferred item in the amount of the capital gains and releasing the deferred item over a period of five years, starting in the year of the relevant transfer. This possibility applies only in the case of a transfer to another EU member state, which arguably is in violation of the EEA Agreement. In contrast, article 5(2) of the ATAD refers to a deferral that requires making installment payments over five years, and also provides this deferral opportunity for transfers to EEA countries. The German exit tax rules will need to be amended regarding this point, at least in cases where the EEA country provides assistance in the recovery of tax claims. In addition, the scenarios described in article 5(4) of the ATAD that require installment payments to be discontinued and render the remaining tax debt recoverable will need to be introduced into German tax law.

Germany currently does not charge interest on deferred exit taxes, and requests

guarantees only in specific cases. Whether this will change as a result of the implementation of the ATAD remains to be seen, since the ATAD allows, but does not require, member states to charge interest.

The ATAD is silent on a "transfer of functions." German regulations for the cross-border transfer of functions (which can be found in section 1(3) of the Foreign Tax Act and related administrative decrees) are, therefore, not expected to be affected by the ATAD.

To ensure the avoidance of double taxation, the ATAD requires member states to take into account the value of an asset that was subject to the exit taxation rules as the starting value for tax purposes, i.e. the asset will be deemed to be acquired at such a value for the purposes of calculating amortization and subsequent capital gains. However, Germany already has such rules for assets that are moved into the German taxing net, which are not contingent on an exit tax being levied in the other state, so it remains to be seen if these rules will be changed.

The exit tax rules, as described in the ATAD, must be introduced into German tax law with effect as from 1 January 2020, at the latest.

**GAAR (Article 6 ATAD)**
Germany has a long-standing GAAR in its domestic tax law (section 42 of the General Tax Code), based on a principal purpose test, so no, or only minimal, action should be required regarding this point. In addition, more specific anti-abuse rules with regard to targeted structures/pressure points exist in German tax law; the anti-treaty shopping provision of section 50d(3) of the tax code (ability to rely on treaty/directive withholding tax benefits) may be one of the more prominent ones.

**CFC rule (Articles 7 and 8 ATAD)**
Although Germany's CFC rules were introduced in 1973 and have been amended frequently, the current rules have been criticized for no longer reflecting economic reality. Even before the ATAD was finalized, the German government announced that it is working on an overhaul of the CFC rules (the details of which are still unclear). Based on the rules contained in the ATAD, the most notable changes that could be expected if the German legislature intends to align the German CFC rules to the ATAD are the following:

- The German CFC rules currently define low-taxed income as income of the CFC that is subject to an effective tax burden of less than 25%. Article 7(1) lit. b of the ATAD defines "minimum taxation" as a case where the CFC is taxed at less than 50% of the effective tax rate in the parent company member state. However, since the ATAD prescribes only a minimum level of protection, Germany will not have to amend its CFC rules where those rules are stricter than the ATAD. Germany, therefore, should be allowed to keep the definition of low taxation at the current level of 25% (even if this is heavily criticized as being too high).
- Under current CFC rules, dividends (generally) and capital gains from the sale of shares (under certain circumstances) are treated as active income and, therefore, need not be included under the CFC rules. However, based on article 7(2) lit. a of the ATAD, dividends and capital gains will have to be included under the CFC rules in the future. How such an inclusion will fit into the overall structure of the current German CFC rules remains to be seen.
- As an alternative to the categorical approach of defining passive income, the ATAD allows member states to implement CFC rules so that they target income from non-genuine arrangements (article 7 (2) lit. b), which means that the CFC would not have owned the assets or have taken the risk if it were not controlled by a company with the significant "people functions." Such a category does not exist under the current German CFC rules, and it is unlikely that Germany will substantially modify its current approach.
- Article 8(4) of the ATAD provides that CFC income must be included in the tax period of the taxpayer in which the tax year of the entity ends. However, under the current German CFC rules, the income of the CFC has to be included at the taxpayer level only after the fiscal year of the entity has ended.

**Hybrid mismatches (Article 9 ATAD)**
Germany introduced an anti-hybrid rule in 2013, under which the 95% participation exemption for dividends is denied if the payment qualifies as a tax-deductible expense for local country purposes at the level of the payer. An anti-hybrid rule for outbound payments covering double-deduction and deduction-no inclusion scenarios has been under discussion since 2014. A first draft law was published at the end of 2014, but has never been enacted. The German legislature has announced it will introduce an anti-hybrid rule for

outbound payments that is in line with the BEPS recommendations and the ATAD, either later in 2016 or early in 2017. Details are still unclear but, based on the short description in the ATAD, the German legislature should have broad discretion in implementing such a rule.

**Comments**
It unlikely that all measures described in the ATAD will be introduced into German tax law at the same time. The most eagerly-awaited measure is likely to be the implementation of an anti-hybrid rule based on article 9 of the ATAD.