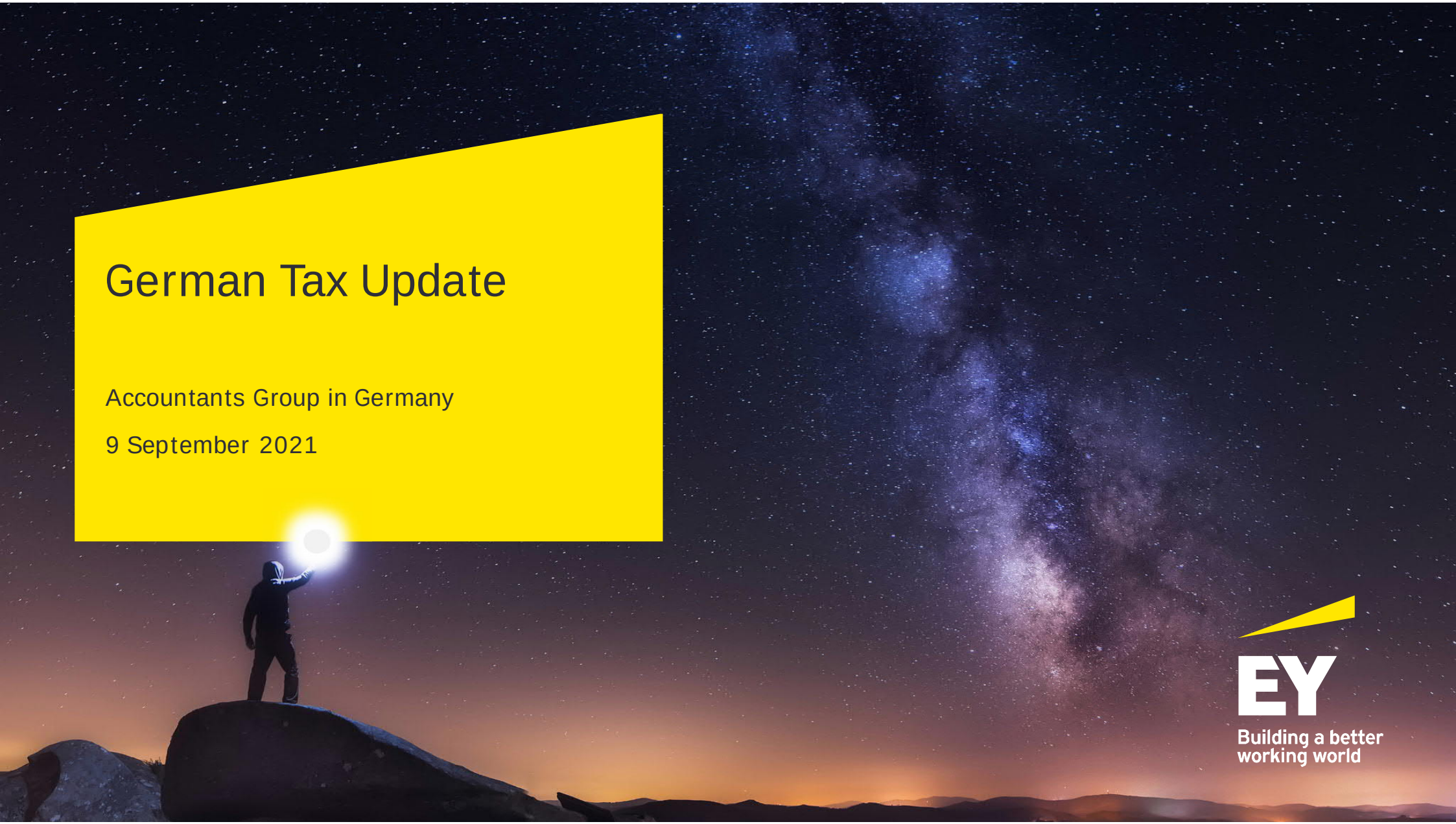
German Tax Update

Accountants Group in Germany

9 September 2021



Building a better working world

German Tax Update - Agenda

1. Hybrid mismatch rules
2. Anti-treaty shopping rules
3. Foreign-to-foreign IP transactions
4. OECD Pillar 1 / Pillar 2

Dirk Lambrecht
Associate Partner
Tel. +49 6196 996 10382
Mobil +49 160 939 10382
E-Mail dirk.lambrecht@de.ey.com

German anti-hybrid rules (ATAD II)

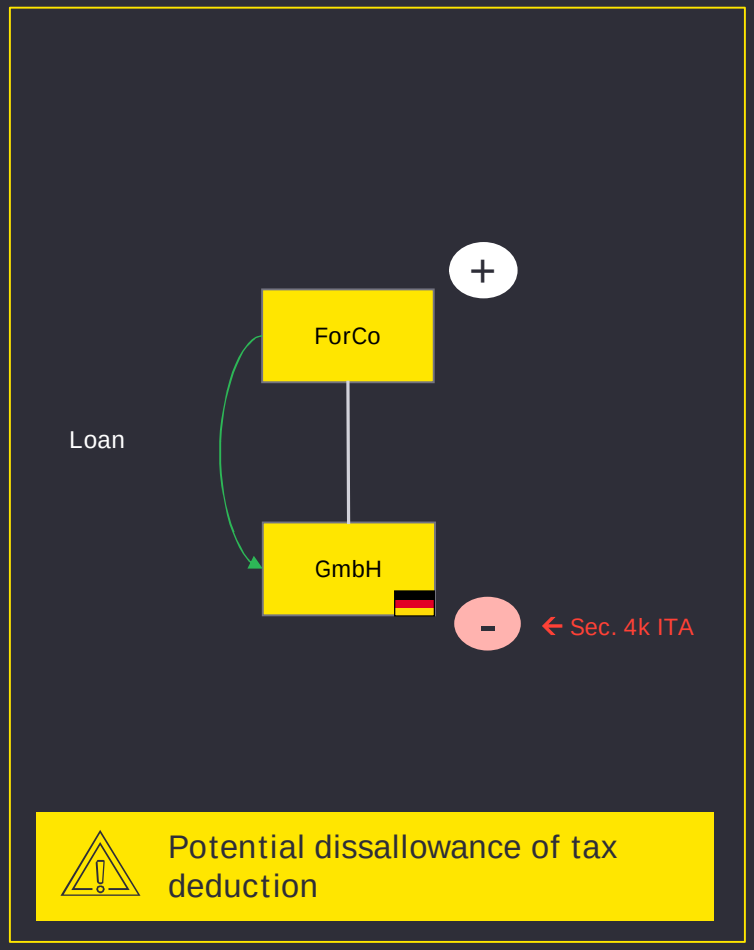
German anti-hybrid rules
Overview

- Broadly following ATAD concept but not a literal transposition, worded very general and vague
- Deductions are generally denied for expenses
  - on hybrid financial instruments;
  - of hybrid entities; or
  - from payments to reverse hybrids, or
  - in PE mismatch situations.
- Generally covering all kind of transactions and expenses (including amortization), not only financing
- Imported mismatches are covered and not subject to any safe harbor rules
- The rules concerning deduction / non-inclusion (D/NI) scenarios only cover cases where the foreign non- or low taxation is triggered by a hybrid mismatch
- In double deduction (D/D) scenarios, deductions are denied for payments which are deductible in Germany and any other jurisdiction even without a hybrid element
- Very narrow dual-income inclusion rules are provided for

German anti-hybrid rules
Overview

- Generally applicable for all expenses accruing after 31 December 2019, however a (rather narrow) exception applies for expenses already caused before 1 January 2020
- Expenses are deemed to not accrue after 31 December 2019 if
  - The expense was “legally caused” before 1 January 2020; and
  - It is not a recurring/continuing obligation (e.g., interest payments on a loan, rent, royalty etc.); or
  - Avoiding the expense would have resulted in a significant disadvantage for the taxpayer and the underlying agreement was not been changed significantly since 1 January 2020
- Questionable whether retroactive implementation for 2020 in 2021 is allowed under constitutional principles, at least to the extent the rules exceed ATAD minimum standards (including rules for reverse hybrids) doubtful
- Challenge in court likely but could take several years

German anti-hybrid rules
Overview



Sec. 4k ITA – expenses after 31 Dec. 2019

Sec. 4k ITA mainly (but not only) targets inbound financing structures and denies the deduction of expenses in certain cases between related parties (group transactions)

DNI

Para. 1
Deviating qualification (hybrid financial instruments) or deviating attribution by the foreign country (hybrid transfers)

Para. 2
Non-taxation of the transaction between a hybrid entity and its shareholder or between permanent establishments of a company.

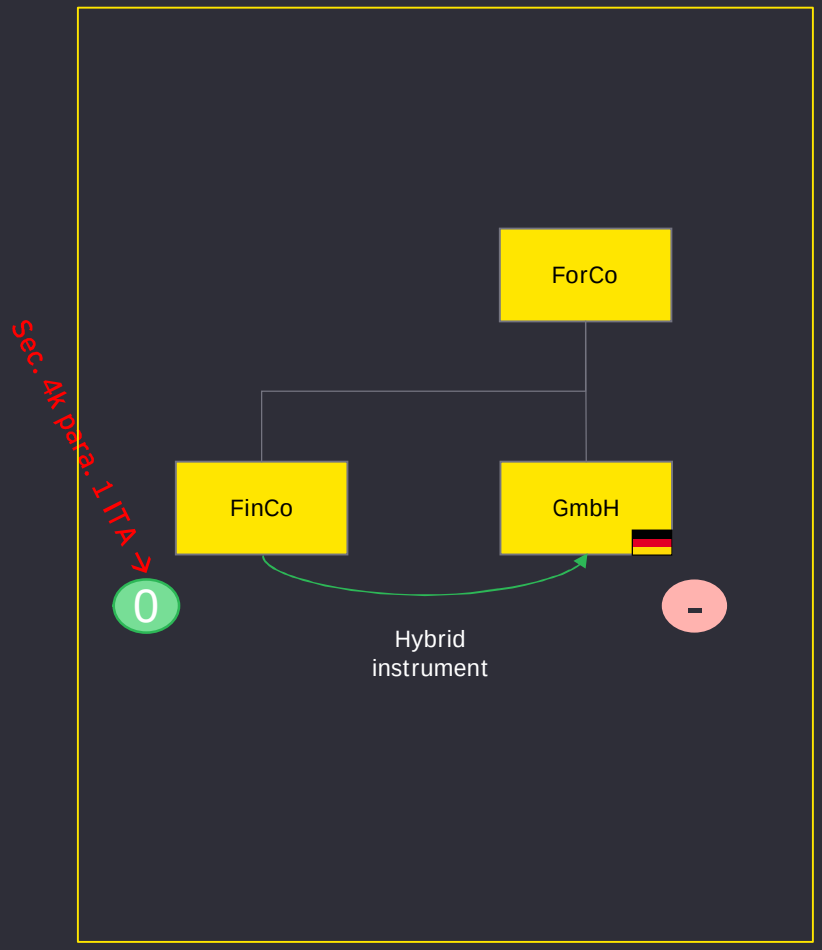
Para. 3 – „catch all“ clause
Deviating assignment or attribution by the foreign country

DD

Para. 4
Double-deduction of expenses

Para. 5 - imported mismatches (applicable for Sec. 1 to 4)

German anti-hybrid rules
Hybrid instruments (Sec. 4k para. 1 ITA)



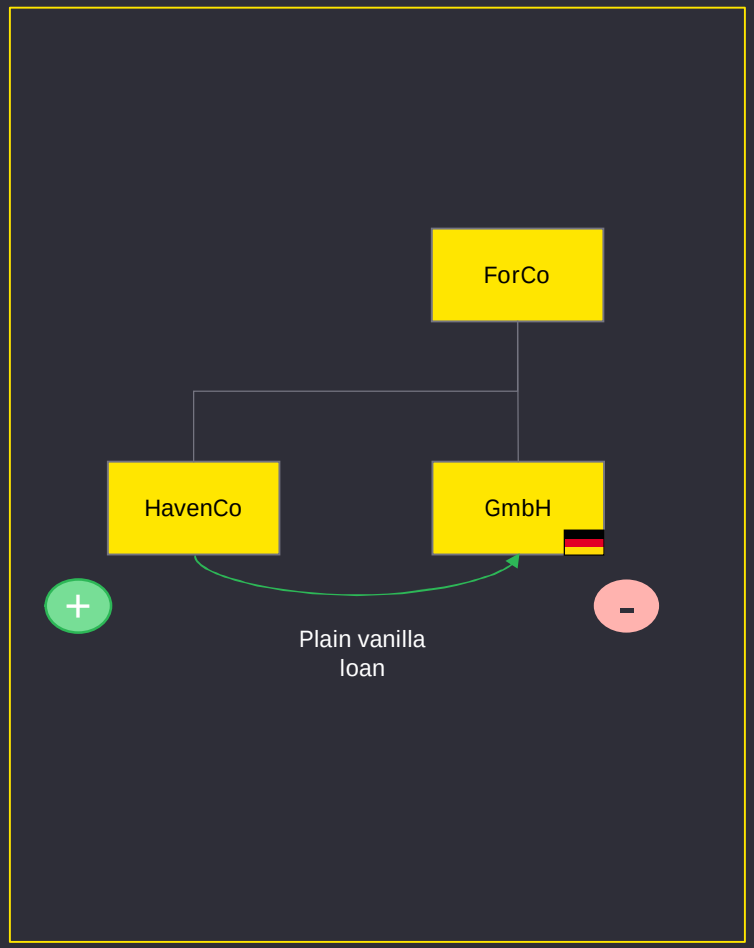
Facts and circumstances

- GmbH is opaque for all relevant jurisdictions.
- FinCo grants a hybrid instrument to GmbH.
- For FinCo's tax purposes, the payments from the hybrid instruments qualify as remuneration for equity (tax exempt dividends). For German tax purposes, the payments qualify as deductible interest expenses.

German hybrid mismatch rule

- The deduction of the expenses at the level of GmbH shall be denied because the respective income is not/low taxed due to the hybrid qualification of the instrument.

German anti-hybrid rules
Low taxed income



Facts and circumstances

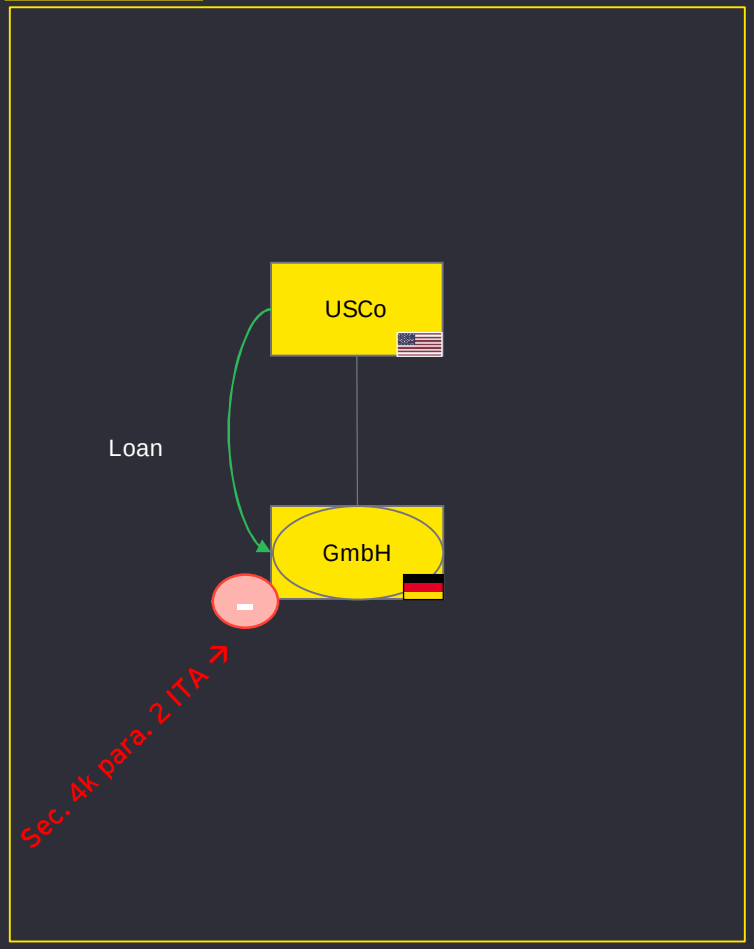
- HavenCo resident in a tax haven has granted an interest bearing loan to a German GmbH; the interest expenses of GmbH reduce the taxable income in Germany.
- At the level of HavenCo, the interest income is not taxed or only taxed with a very low tax rate.
- All entities are viewed as corporations; no hybrid element.

Indicative assessment under ATAD implementation

- German anti-hybrid rules do not restrict interest deduction as no hybrid element in the structure
- Interest expense deduction might be denied based on transfer pricing rules

German anti-hybrid rule

Deduction / non-inclusion (Sec. 4k para. 2 ITA)



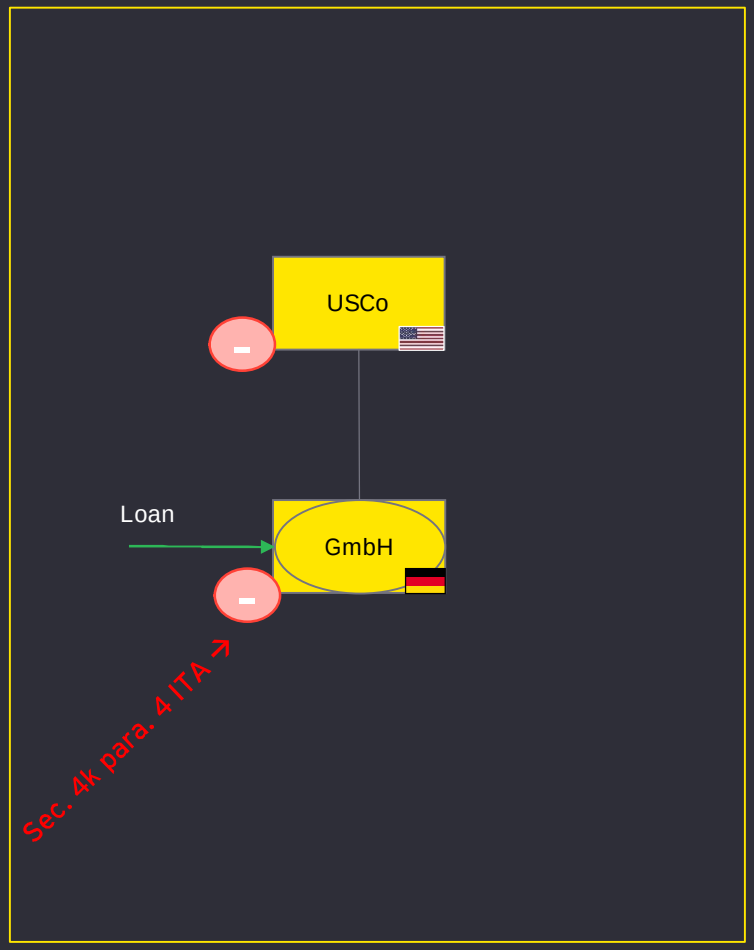
Facts and circumstances

- GmbH is opaque for German tax purposes and disregarded for US tax purposes (check the box election).
- USCo grants a loan to GmbH.
- The loan is disregarded for US tax purposes.
- GmbH has interest expenses.

German hybrid mismatch rule

- The deduction of the expenses at the level of GmbH shall be denied because the respective income is not taxed in the US due to the hybrid qualification of the GmbH.
- Dual income inclusion rule may apply

German anti-hybrid rules
Double deduction (Sec. 4k para. 4 ITA)



Facts and circumstances

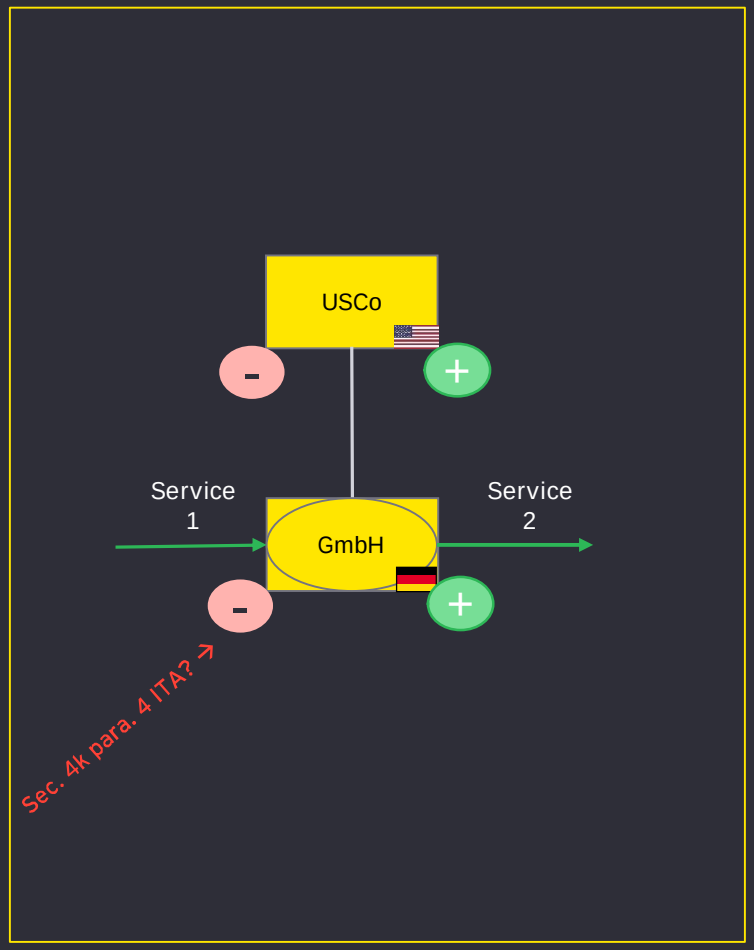
- GmbH is opaque for German tax purposes and disregarded for US tax purposes (check the box election – hybrid entity).
- Third party (bank) grants a loan to GmbH.
- The interest expense is deducted at the level of GmbH and at the level of USCo as GmbH is disregarded

German hybrid mismatch rule

- The deduction of the expenses at the level of GmbH shall be denied because the hybrid qualification of GmbH results in a double deduction of the interest expense.
- Dual income inclusion rule may apply

German anti-hybrid rules

Typical German Inbound-structures – double deduction



Facts and circumstances

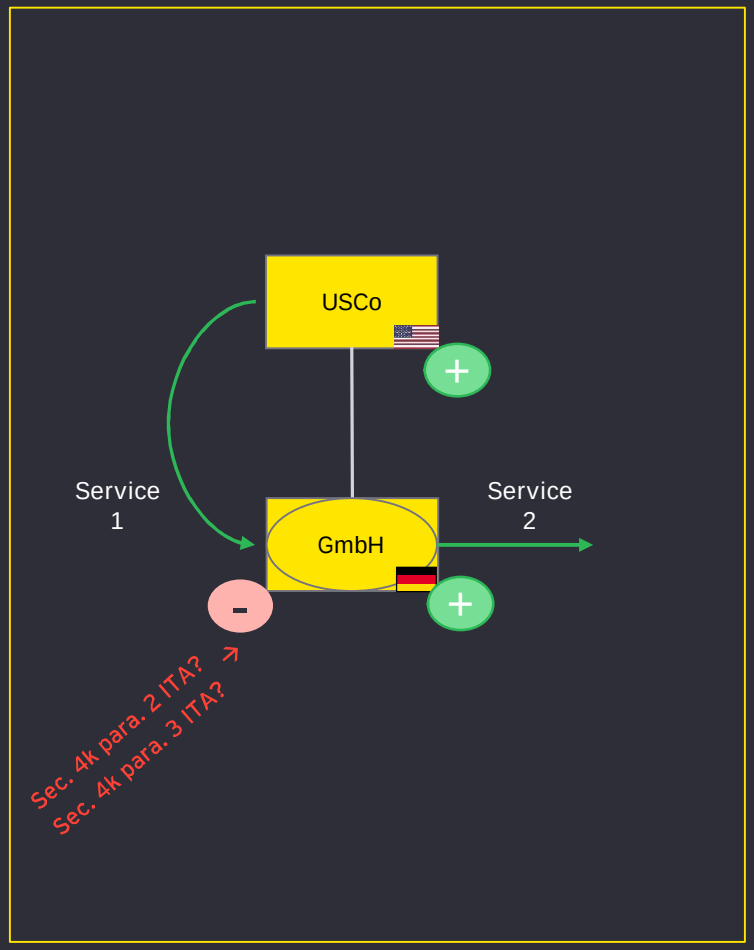
- GmbH is opaque for German purposes and disregarded for US purposes (hybrid entity).
- GmbH has expenses stemming from received services (Service 1) and income from provided services (Service 2).
- For German tax purposes, the expenses and the income are included in the tax base of GmbH.
- For US tax purposes, the expenses and the income are included in the US tax base of USCo.

German hybrid mismatch rule

- Due to the double-deduction of expenses, the German anti-hybrid clause might apply, however, dual-income inclusion rule may apply:
  - The same expenses (for Service 1) are subject to a double deduction in Germany and the US.
  - The escape clause should apply as the income from Service 2 is also included in the US tax base.

German anti-hybrid rules

Typical German Inbound-structures – deduction/non-inclusion

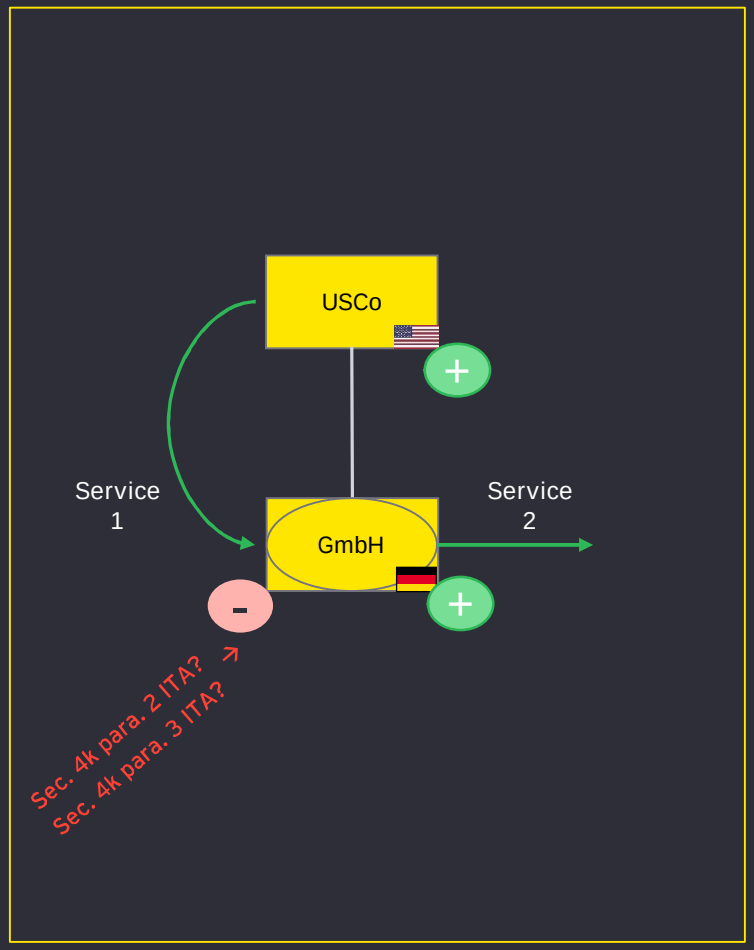


Facts and circumstances

- GmbH is opaque for German purposes and disregarded for US purposes (hybrid entity).
- GmbH has expenses stemming from received services from US parent (Service 1) and income from provided services (Service 2).
- For German tax purposes, the expenses and the income are included in the tax base of GmbH.
- For US tax purposes, the expenses and the income resulting from Service 1 are disregarded as GmbH is opaque.
- The income resulting from Service 2 will be considered at the level of GmbH and at the level of USCo.

German anti-hybrid rules

Typical German Inbound-structures – deduction/non-inclusion



German hybrid mismatch rule

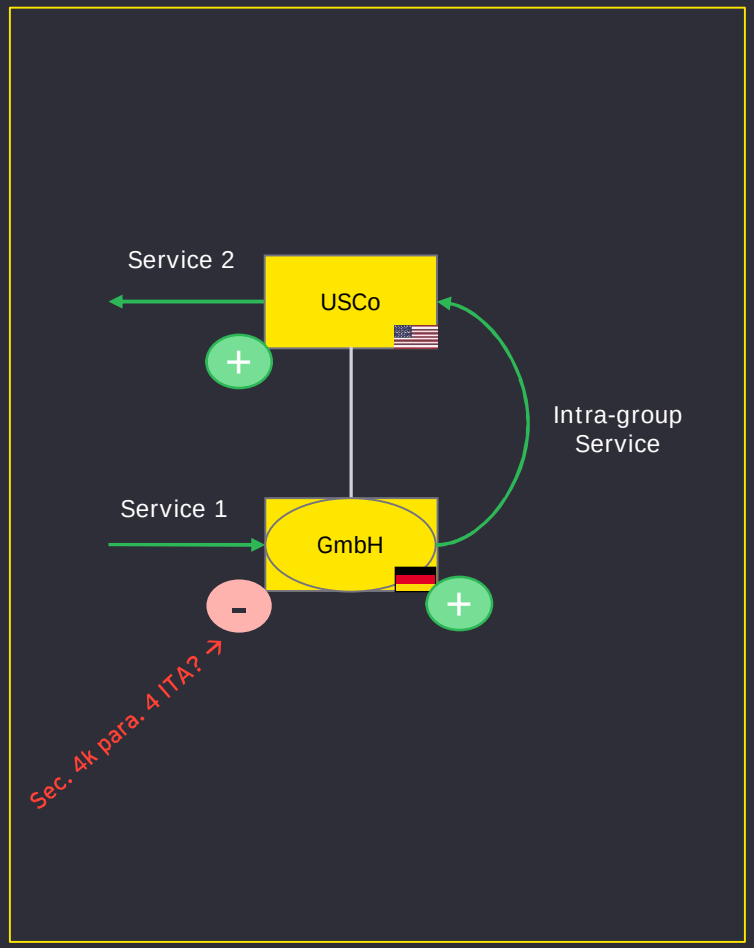
- The income from Service 1 is not taxed in the US → deduction / non-inclusion (§ 4k Abs. 2 S. 1 EStG).
  - Dual income inclusion rule should apply as expenses are offset by income that is taxed in both Germany and the USA → dual-income-inclusion rule (Sec. 4k para. 2 s. 3 ITA).

However,

- The expenses are also not deductible to the extent that the income corresponding to the expenses is not subject to actual taxation in any state due to deviating allocation or attribution of the income → deduction / non-inclusion, however, Sec. 4k para. 3 ITA does not include a dual-income-inclusion rule
- Based on the pure wording of the law, the expenses should not be tax deductible.
- However, it could be argued that based on the purpose of the law, a deduction should still be possible, even if not provided for by law.

German anti-hybrid rules

Typical German Inbound-structures – double deduction



Facts and circumstances

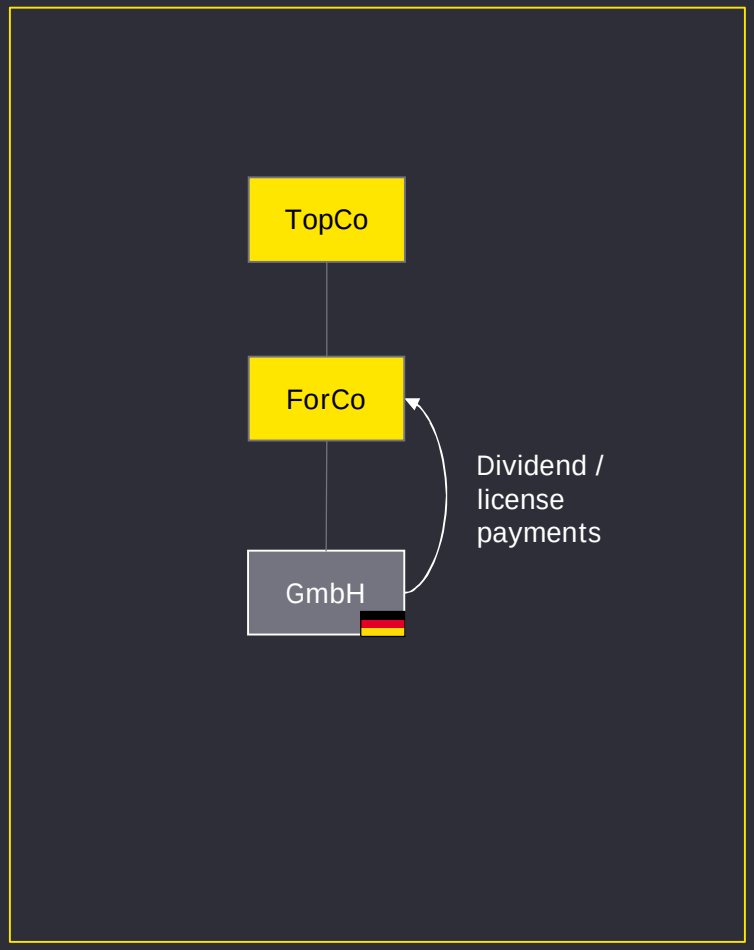
- GmbH is treated as disregarded by the US and as opaque by Germany (hybrid entity). USCo is treated as opaque by Germany/USA.
- GmbH receives services from third parties (Service 1) and provides services to USCo (intra-group service). USCo provides services to third parties (Service 2). The intra-group service is disregarded for US tax purposes.
- Expenses for Service 1 are deductible in Germany and in the US. The income stemming from Service 2 is taxed in the US.

German hybrid mismatch rule

- Due to the double-deduction of expenses, the German anti-hybrid clause should apply so that a deduction for expense for Service 1 could be denied:
  - The same expenses (for Service 1) are subject to a double deduction in Germany and the US (GmbH is disregarded for US tax purposes).
  - From a US-perspective the intra-group service is disregarded. There is technically no double-inclusion of the same income and, hence, likely no escape can be applied based on a strict interpretation of the wording of Sec. 4k para. 4 s. 3 ITA.
  - A wide interpretation of the dual income inclusion may be applied, but against the wording of the law.

Revision of German anti-treaty shopping rules

Revision of German anti-treaty shopping rule
Overview



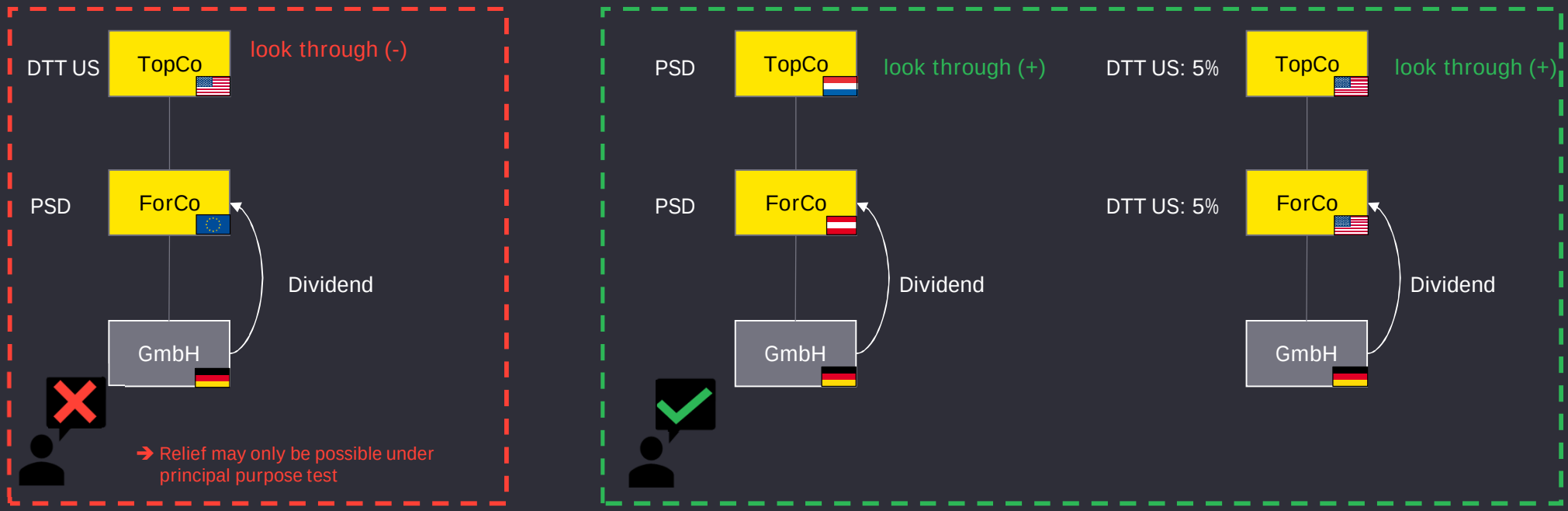
- Relief from German WHT under the tax treaty and/or under applicable EU Directive can only be granted to the extent that the foreign beneficiary fulfils the
  - Personal Entitlement Test (shareholder of the foreign beneficiary must be entitled to the very same relief from German WHT if they received the income directly ("look through")) or
  - Substance Test (source of income must be substantially linked to economic activities of the foreign beneficiary;).
- If neither Personal Entitlement nor the Substance Test are met the Principal Purpose Test or the Publicly Listed Exception might be available.

- In a nutshell the new German anti-treaty shopping rule has been tightened in many aspects. In particular the scope of the Personal Entitlement Test has been narrowed and the Publicly Listed Exception shall not apply on higher level tier. Therefore, inbound multinationals which relied on substance (or the publicly listed exception) at the top tier level will struggle to gain relief from German WHT under the tax treaty / applicable EU Directive.

Revision of German anti-treaty shopping rule

Personal Entitlement Test

Are there shareholder of the foreign beneficiary entitled to the very same relief from German WHT if they received the income directly?



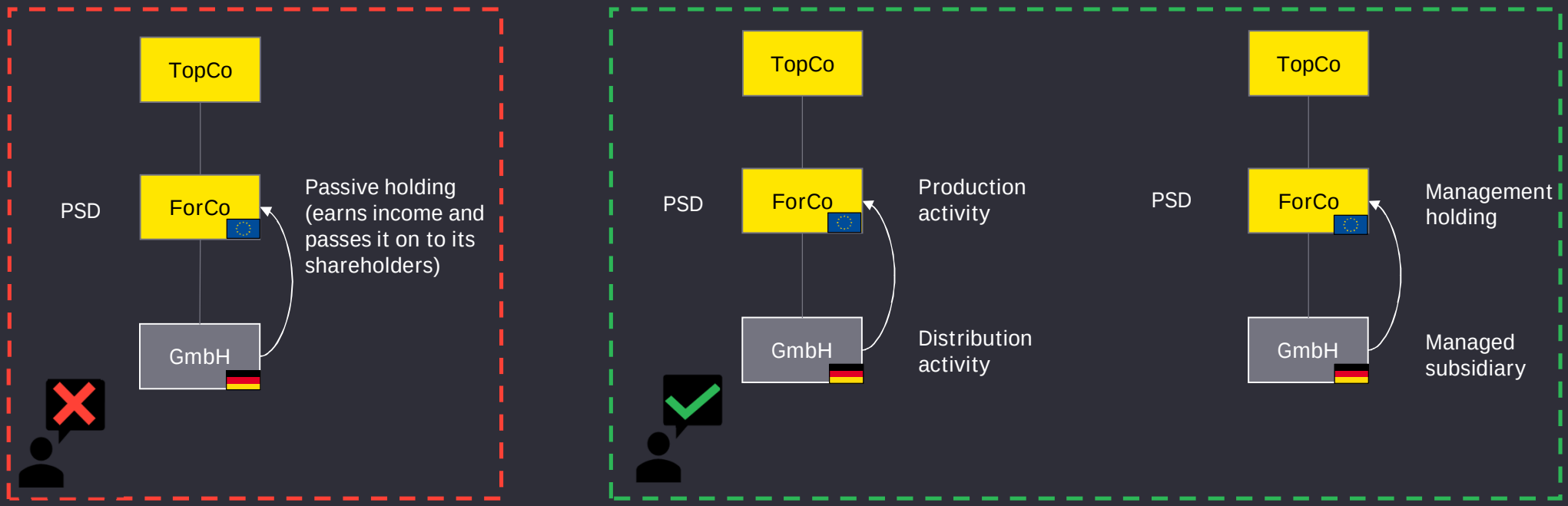
Only look through if the same benefits under the same legal instrument

- Different tax treaties (with same level of relief) no longer qualify
- Combination of tax treaty and EU Directive (with same level of relief) no longer qualifies
- Equivalent access to EU PSD should qualify.

Only if entitled to the same benefits under the same legal instrument, shareholder higher up the chain can demonstrate functional connection / purpose test.

Revision of German anti-treaty shopping rule
Substance Test

Source of income substantially linked to economic activities of the foreign beneficiary (i.e. ForCo in the examples below)

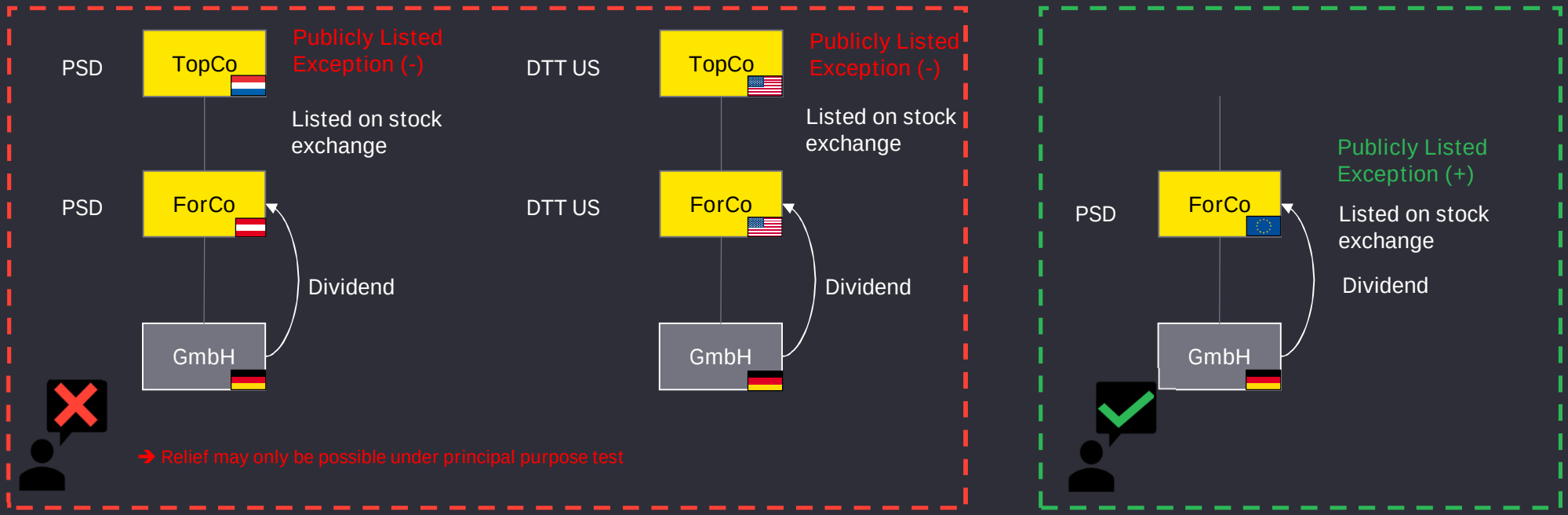


Passive holding companies unlikely to qualify under new rules; the mere receiving and forwarding of income is deemed as no economic activity
True management holding should still qualify

- Key questions:
  - Is there an economic reason why the shareholding is held by ForCo?
  - What level of management activities is needed to substantiate economic connection between ForCo and managed subsidiary?
  - Is the substance in line with the business purpose?

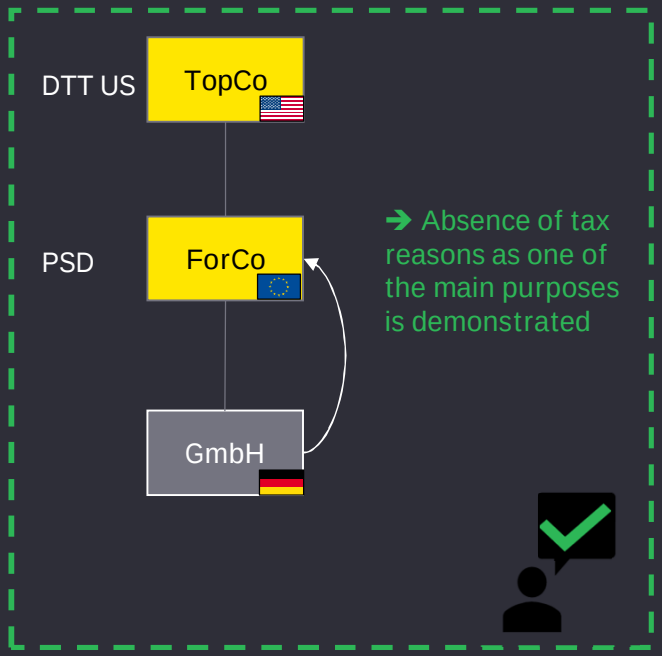
Revision of German anti-treaty shopping rule
Listed Company Exception

Is the foreign beneficiary is an entity whose principal class of shares are regularly traded on a recognized stock exchange?



Based on the explanatory notes to the bill the exception for listed companies will only apply if the applicant entity itself (ForCo) is publicly listed. However, if the ultimate parent (TopCo) is publicly listed the exception shall not be applicable.

Revision of German anti-treaty shopping rule
Principle Purpose Test



Based on the Principal Purpose Test the tax payer has to demonstrate that none of the main purposes of the interposition of the entity was the realization of a tax advantage.

Key question: Can the taxpayer demonstrate that none of the main purposes of interposition of the entity (i.e. ForCo) was realization of a tax advantage?

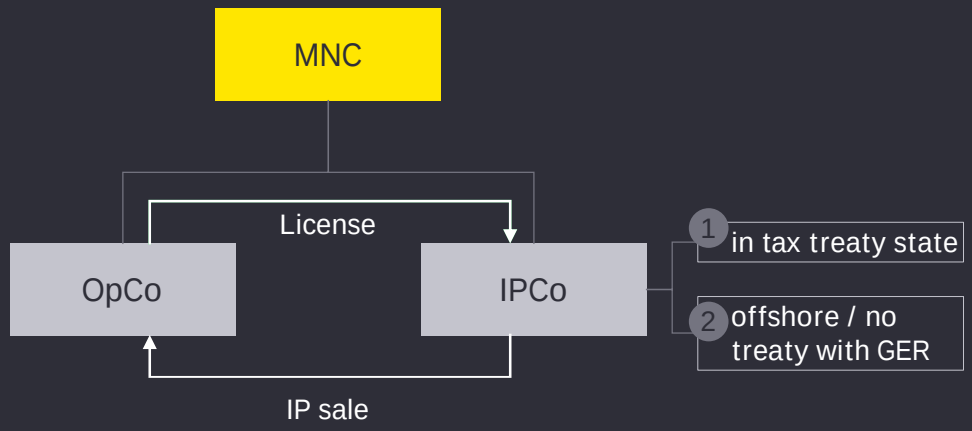
- Tax benefit can be any benefit in any country (not limited to German withholding tax)
- Very difficult to demonstrate the absence of something
- Motivation for structure will likely have to be included in every application letter

- No upfront certainty for structures prior to their implementation; may require adding functionality and substance later if treaty/PSD eligibility is not accepted.

Foreign-to-foreign IP transactions

(Sec. 49 ITA)

Foreign-to-foreign IP transactions
Overview



Facts and circumstances

- IP is registered in the German Patent and Trademark Register (Deutsches Patent- und Markenamt (DPMA))
- Foreign taxpayer receives license income or capital gains.
- License: Licensee is also a foreign tax payer
- Capital gain: Tax residency of Acquirer is not relevant

Alternatives:

- Licensor/IP seller is tax resident in a treaty country.
- Licensor/IP seller is tax resident in country which has not concluded a tax treaty with Germany

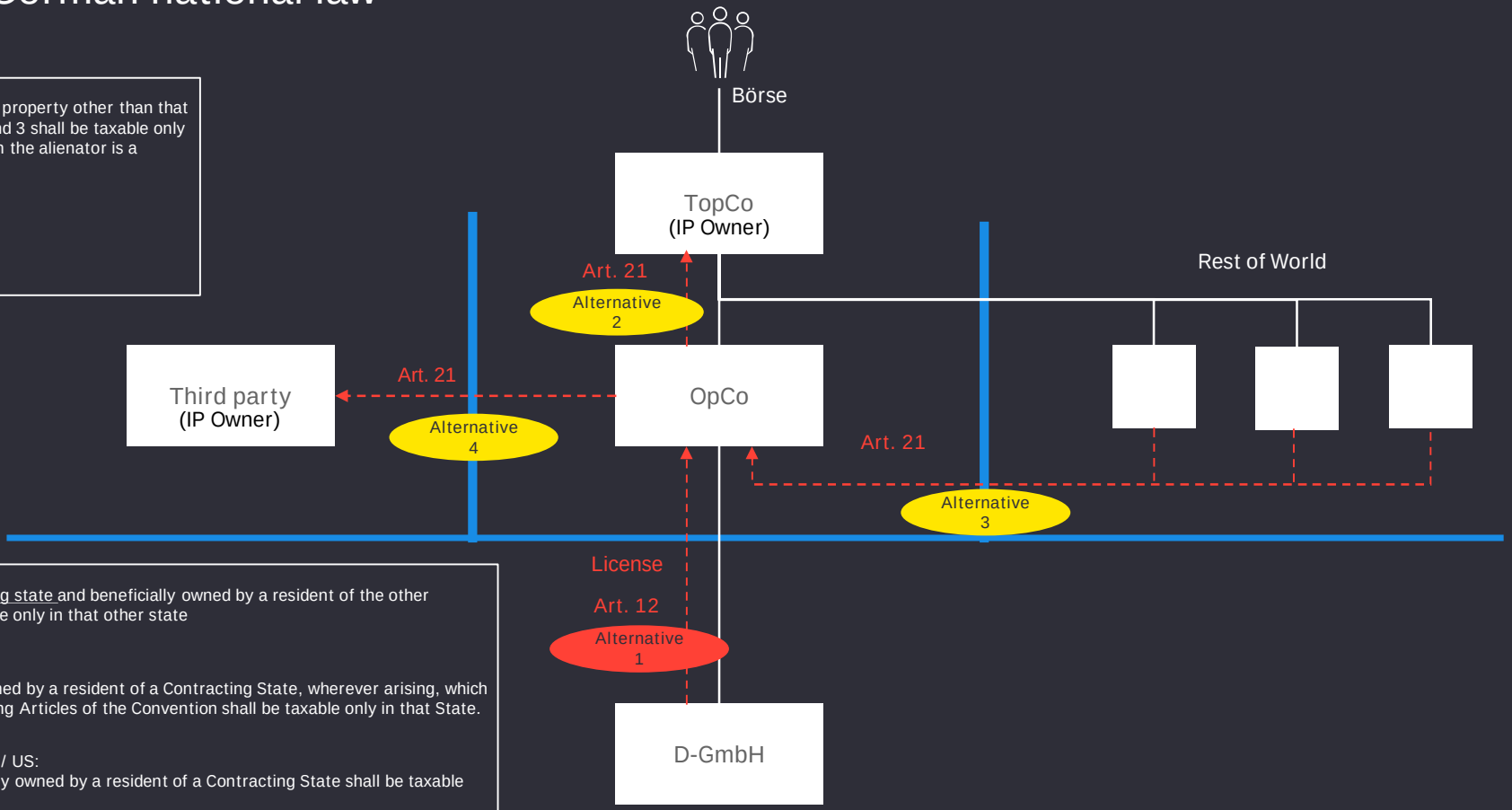
§ 49 Abs. 1 Nr. 2 f EStG lautet: Inländische Einkünfte … sind Einkünfte aus Gewerbebetrieb … durch
a) Vermietung und Verpachtung oder b) Veräußerung,
von inländischem unbeweglichen Vermögen, **von Sachinbegriffen oder Rechten**, die im Inland belegen oder **in ein inländisches öffentliches Buch oder Register eingetragen sind** oder deren Verwertung in einer inländischen Betriebsstätte oder anderen Einrichtungen erfolgt, erzielt werden.

Foreign-to-foreign IP transactions

Tax treaty vs. German national law

Art. 13 (4) tax treaty:
Gains from the alienation of any property other than that revered to in paragraphs 1, 2 and 3 shall be taxable only in the Contracting State of which the alienator is a resident.

→ No German treaty override



Art. 12 (1) tax treaty:
Royalties, arising in a contracting state and beneficially owned by a resident of the other contracting state shall be taxable only in that other state

Art. 21 (1) tax treaty:
Items of income beneficially owned by a resident of a Contracting State, wherever arising, which are not dealt with in the foregoing Articles of the Convention shall be taxable only in that State.

Art. 12 (1) tax treaty Germany / US:
Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that state

→ But treaty override in German national law with view to withholding taxes and German anti-treaty shopping rules

Foreign-to-foreign IP transactions
Specific questions

- Capital gain transactions:
  - Who is the economic owner of the IP?
  - Is actually a sale by the economic owner (based on German tax principles) undertaken?
- Definition of „sale“:
  - Ownership in an asset is transferred to another party against consideration
  - Contribution into the share capital against the issuance of shares
  - Rather not a sale:
    - Hidden contribution / hidden distribution or distribution in kind (depending on how it is structured)
    - Withdrawal from a partnership
    - Transfer of IP into a foreign branch
    - Change in tax status (e.g. change of place of management from a non-treaty country to a treaty country)
- Income attribution:
  - Income attributable to Germany / German registered rights
  - Book values / step-up from prior transactions?
  - Should depreciation of tax book value be taken into account?
  - How should cost-sharing payments be taken into account?

Foreign-to-foreign IP transactions
How to move forward

Differentiation between non-treaty and treaty cases

Non-treaty cases:

- Obligation to file withholding tax returns / capital gains tax returns and payment of related taxes

Treaty cases:

- Licenses
  - No obligation to file tax returns and payment of taxes to the extent
    - The licensor is without doubt treaty protected and
    - The licensor applies for a withholding tax exemption certificate with the Federal Central Tax Office until June 2022 for past and current transactions;
- Capital Gains
  - Tax authorities take the view that also in treaty cases, a capital gains tax return has to be filed

Open years:

- Obligation to file tax returns for all years not yet time-barred.
- Generally 7 years if no tax return has been filed so far → relevant for all transactions since 2013
- Longer look-back period if tax evasion would be assumed.

OECD Pillar 1 / Pillar 2

“New World Tax Order”

OECD Pillar 1 / Pillar 2
Overview

Sep 2013
15 Action points

Okt 2015
Final Report on Base Erosion and Profit Shifting ...

01.07.2021
Publishing of OECD/G20 Inclusive Framework

10.07.2021
Agreement of G20 Finance Ministers

Overview

- Pillar 1
  - Original approach: Drivers of BEPS 2.0 to achieve "fair" taxation of digital companies.
  - Now: New taxation right („Amount A“) applicable to big multinationals (>20bn EUR turnover) with high profitabliity (>10% pre-tax return) of all industries.
  - Amount B unchanged as a „safe harbour“ rule for routine distribution activities, however, scope is unclear as of today.
  - Dispute avoidance /-resolution only relevant for Amount A.
- Pillar 2
  - Due to scope of the rule (applicable for all groups with turnover >750m EUR) Pillar 2 is now more important pillar.
  - Effective tax rate of at least 15%.

Political background

- Is politically intended (G7/G20/IF: 132/139) and will therefore be implemented.
- Timing is very ambitious (application from 2023), however, due to broad political support realistic.
- Coordinated and consistent global implementation and application of utmost importance.
- Which reaction are expected?
  - From low tax jurisdictions?
  - From countries with digital service tax?
  - From companies?
- Influence of the USA on Pillar 2
- Efforts to globally standardize income taxation go hand in hand with - equally politically desired - new indirect taxes.

OECD Pillar 1 / Pillar 2

Pillar 1 – Amount A / Amount B

Amount A

Quantitative Approach: "Targeting the largest and most profitable MNEs"

- Global revenue > 20bn EUR und Profitability > 10% (profit before tax / revenue)
- After 7 years turnover threshold reduced to 10bn. EUR
- Not applicable to: Commodity industry and regulated financial services
- Re-allocation of 20-30% of residual profits above the 10% profit margin
- Re-allocation of amount A on turnover of at least EUR 1m in the market state (EUR 250k if GDP < EUR 40bn)

Amount B

Safe harbor rule for low risk distributors

- Amount B is the remuneration of group companies located in a market where baseline marketing and distribution activities are carried out for a multinational group.
- The aim of introducing Amount B is to standardize the remuneration of distribution companies in multinational groups.
- TNMM (transactional net margin method; Sales/EBIT) as an appropriate transfer pricing method; conducting a database analysis based on data from unrelated comparable companies.
- Determining different returns on sales depending on geographic location, industry or functional intensity.

OECD Pillar 1 / Pillar 2

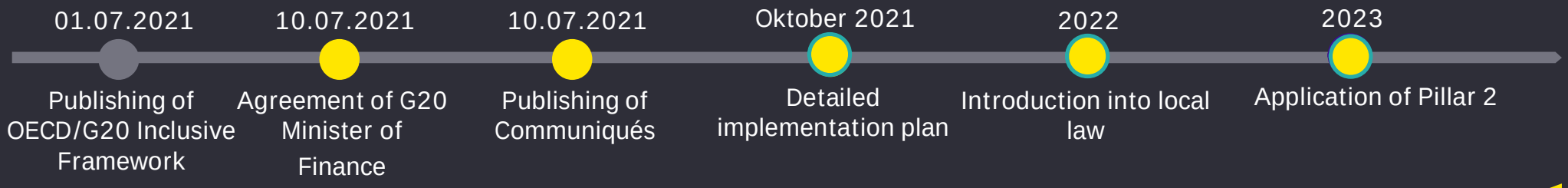
Pillar 2 – overview

- Introduction of a global Minimum Tax Rate of „at least 15%“.
- Minimum Tax will be determined on the basis of an effective tax rate and not on the basis of nominal tax rate.
- Effective tax rate will be calculated on a consolidated country level.

- Option to implement the rules
  - But: Obligation to accept the implementation of the rules by other countries.
- Difference to Pillar 1: Implementation can be undertaken at a national level.

- Application for multinational groups, with a turn-over of more than EUR 750 Mio. (CbCR-threshold)
  - Income Inclusion Rule could also be implemented below the agreed threshold (to be decided by each country)

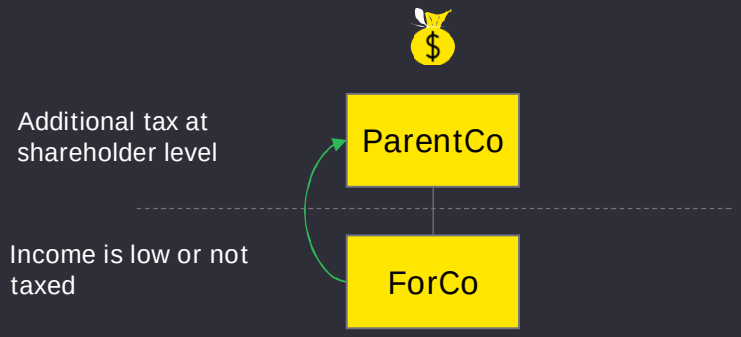
- No application of GloBE-Regeln on government entities, international organizations, non-profit organizations, pension funds or investment funds if they are Ultimate Parent Entity.



OECD Pillar 1 / Pillar 2

Pillar 2 – proposed rules

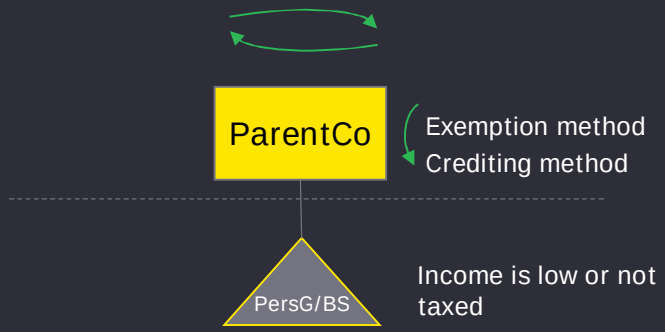
Income Inclusion Rule



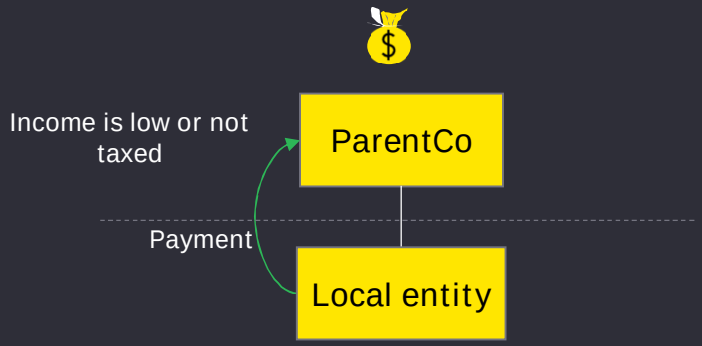
Income Inclusion Rule

Additional tax at the level of the parent entity for subsidiaries with effective tax rate below the agreed minimum tax rate.

Switch-over Rule



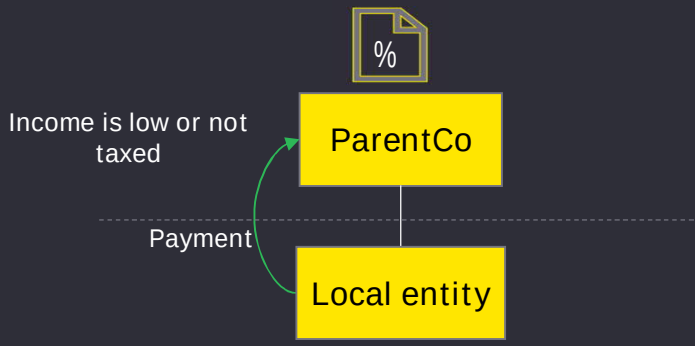
Undertaxed Payments Rule



Undertaxed Payments Rule

Denial of tax deductibility in the source country for specific payments to affiliates if the corresponding income (at the level of the recipient) are taxed at a level below the agreed minimum tax rate.

Subject to Tax Rule



OECD Pillar 1 / Pillar 2
Pillar 2 – open items

- How to calculate the relevant Effective Tax Rate
  - Relevant assessment basis: commercial profit according to GAAP of TopCo; adjustments required, i.e. in relation to dividends received, profits from reorganizations
  - Taxes to be considered: all income taxes and withholding taxes
  - Critical points: Differences to deferred tax accounting, no adjustments for IP regimes in line with BEPS, only limited carve-outs for substance, significant number of open questions.

- Problems in connection with the individual regulations
  - How do Income Inclusion Rule and Undertaxed Payment Rule play together: risk of double taxation
  - How are local tax law rules to be considered (i.e. German CFC taxation, interest / license limitation rules); significant administrative burden and risk of double taxation
  - Implication of US GILTI Regime: effective minimum tax of 21%?

OECD Pillar 1 / Pillar 2
Pillar 2 – Implementation

- Income Inclusion Rule und Undertaxed Payment Rule
  - National implementation taking into account OECD model regulations & commentary, but compatibility with treaty law disputed.
  - If necessary, introduction of a multilateral agreement for the (internationally) legally binding specification of principles and core elements in connection with GloBE regulations.
  - Implementation to be monitored/reviewed by a peer review process.
  - Open: EU Directive / Implementation in the USA?

- Switch Over Rule und Subject to Tax Rule
  - Implementation required under tax treaty.
  - Bilateral negotiations/amendments of existing tax treaties.
  - Supplement to the MLI; alternatively: independent multilateral convention.

Thank you!

Questions

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

In this presentation, “EY” and “we” refer to all German member firms of Ernst & Young Global Limited. Each EYG member firm is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. For more information about our organization, please visit ey.com.

In Germany, EY has 20 locations.

ABC JJMM-123
ED None

ey.com/de