Client Alert

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Germany: Changes in transfer pricing rules

Content

Below, we provide an overview of recent developments in the area of transfer pricing and related topics of international taxation.

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I. Codified Law and International Agreements

1. Procedural changes in tax audits

a) Submission of transfer pricing documentation and requests for cooperation

The Act on the Implementation of the DAC7 Directive (EU) 2021/514 ("**DAC7 Implementation Act**") contains procedural simplifications and stricter statutes for tax audits. The legislator relies on the concept of carrot and stick. The following regulations came into force on 1 January 2023 and apply for the first time to taxes and tax refunds arising after 31 December 2024.

In tax audits, a voluntary, discretionary **determination of audit priorities** (Sec. 197 (3) and (4) German Fiscal Code (AO)), the **agreement of interim discussions** (Sec. 199 (2) AO) and the conduct of **virtual negotiations and meetings** (Sec. 201 (1) AO) are now possible. In addition, the **relocation of accounting abroad** is facilitated according to modern times, as several foreign countries can be parallel accounting locations (Sec. 146 (2a) and (2b) AO).

Regulations on the submission of **transfer pricing documentation** have been changed. According to the new rules, taxpayers must submit transfer pricing documentation reports within 30 days upon receiving the audit order, i.e., the tax audit must not issue a separate request for transfer pricing documentation reports. From a practical perspective, this means that taxpayers will have to produce transfer pricing documentation promptly and on an ongoing basis.

A so-called **qualified cooperation inquiry** has been introduced to taxpayers' detriment. Tax auditors will have the opportunity to issue qualified cooperation inquiries to incentivise taxpayers to submit documents and answer information requests. Taxpayers that fail to cooperate with such inquiry within one month will be subject to a penalty of EUR 75 per day of delay for up to 150 calendar days, i.e., up to EUR 11,250 in total. In addition, a surcharge of EUR 25,000 per day of delay for up to 150 calendar days may be considered if further criteria are met.

The new statutes apply to taxes that arise before 1 January 2025 if an audit order is announced after 31 December 2024.

b) Acceleration of tax audits

The **DAC7 Implementation Act** additionally contains a bundle of new procedural regulations, among other things, for the **modernization and acceleration of tax audits**.

Audit orders shall be issued until the end of the calendar year following the calendar year of the tax assessment (provided the tax return was prepared by a tax adviser). The suspension of the statute of limitations due to the tax audit is limited to five years. If no other suspension of the statute of limitations applies, the taxes become statute-barred at the latest five years after the end of the calendar year of the audit order (Sec. 171 (4) AO). The provisions apply for the first time to taxes arising after 31 December 2024. For taxes and tax refunds arising before 1 January 2025, Sec. 171 (4) AO shall continue to apply to the version applicable on 31 December 2022.

c) Award of Tax Compliance Management Systems ("**Tax CMS**")

The new procedural provisions of the **DAC7 Implementation Act** include regulations for in-house tax control systems. For the first time, effective **internal tax control systems** will be rewarded. Tax authorities may, based on corresponding systems, promise binding restrictions on the type and scope of audit procedures for the subsequent tax audit (Art. 97 Sec. 37 Introduction Act to the German Fiscal Code). The binding commitment requires, in particular, that the tax authority has verified the effectiveness of the Tax CMS in a tax audit and (from the tax authority's point of view) has found no or only an insignificant tax risk. The amendment entered into force on **1 January 2023**. The regulation is in place on a trial basis and is to be evaluated in 2029.

2. Public Country-by-Country Reporting

On 21 June 2023, the Act on the National Implementation of Public Country-by-Country Reporting ("**Public CbCR**"), which implements EU Directive 2021/2101 into national law, was promulgated in the Federal Law Gazette. The regulations will apply for the first time for **fiscal years beginning after 21 June 2024**. The Public CbCR obliges certain companies to disclose so-called income tax information reports in the business register and, if applicable, to publish them on the company's website.

The obligation applies to related group companies or trading partnerships and to parent companies domiciled in Germany that have generated sales revenues or consolidated sales revenues of more than EUR 750 million in two consecutive fiscal years. In the case of comparable large groups whose ultimate parent company is based outside the EU, the obligation applies to domestic subsidiaries or branches. (Large) domestic branches of non-affiliated companies based outside the EU may also be subject to the obligation. This is the case if they have achieved sales revenues of more than EUR 12 million in two consecutive financial years, whereby this sales limit may not be fallen short of in the two consecutive financial years after that.

The content and form of the Public CbCR are based on the regulations for the non-public CbCR pursuant to Sec. 138a German Fiscal Code (AO). The mandatory disclosures include the type of business activity, the number of employees, the amount of sales, the profit before tax, and income taxes accrued (excluding deferred taxes) and paid. The information must be broken down for each EU or EEA state and for each non-cooperative tax jurisdiction outside the EU. For all other (cooperative) non-EU jurisdictions, the information is to be aggregated.

Fines of up to EUR 250,000 are provided for non-timely or incomplete submissions of the Public CbCR.

3. Reporting obligation and automatic exchange of information by digital platform operators in tax matters (DAC 7)

The DAC7 Implementation Act introduces new **due diligence** and **reporting obligations** for **platform operators** and is intended to expand the **exchange of tax information** between EU member states. These regulations will be implemented into the newly created **Act on the Reporting Obligation and the Automatic Exchange of Information in Tax Matters by Reporting Platform Operators** (Platform Tax Transparency Act, in German: Plattformen-Steuertransparenzgesetz, PStTG). The PStTG came into force on **1 January 2023**.

The act applies to all digital platforms that enable providers and users to make contact via the internet using software and to conclude legal transactions relating to relevant activities. Platform operators subject to the notification requirement must, among other things, provide information about the platform operator and the platform itself, as well as about the sellers operating on the platform. In addition, platform operators must also fulfil special due diligence obligations, e.g., the obligation to collect reportable information and check its plausibility.

Fines of between EUR 5,000 and EUR 50,000 may be imposed for violations of these obligations. In special cases, the Federal Central Tax Office (Bundeszentralamt für Steuern, BZSt) may prohibit operation and block the platform.

On 2 February 2023, the Federal Ministry of Finance (BMF) published a circular on questions regarding the application of the PStTG. This circular addresses many individual questions and practical problems to support the PStTG's proper implementation. Among other things, it highlights that there is no exemption from the reporting requirements for intra-group platforms. In addition, a draft communication manual for digital platform operators' reporting obligations was published on 1 August 2023. This contains assistance on the technical processing of the notification.

4. Register cases

The **Annual Tax Act** (Jahressteuergesetz, JStG) 2022 adjusted the tax treatment of so-called **register cases**. Register cases relate to income from the temporary transfer of rights entered in a domestic register, as these are subject to limited tax liability under Sec. 49 German Income Tax Act (EStG), even if a foreign licensee pays the royalties. It was and still is highly controversial whether capital gains and royalties from rights entered in German registers could be taxed in Germany even if all the contracting parties involved were resident abroad.

With the introduction of the new regulations in the JStG 2022, the taxation of third-party cases (i.e., the contracting parties are third parties to each other) will now be comprehensively abolished in principle. This applies both to old cases that are still open and to new cases in the future. Taxation is now only conceivable in the following cases:

(1) Register cases are taxed where the licensor/seller of rights is resident in a so-called **non-cooperative jurisdiction** (tax haven) within the meaning of the Tax Haven Defense Act (Steueroasenabwehrgesetz). These cases are also taxable retroactively from 1 January 2022.

(2) The taxation of registered cases between related parties within the meaning of Sec. 1 (2) of the German Foreign Tax Act (AStG) (so-called **group cases)** will continue to apply. An exception applies to payments made on or after 1 January 2023, for which the German right of taxation under a double tax treaty no longer applies and it does not revert by way of a treaty override (e.g., under Sec. 50d (3) EStG). For these cases, exemption applications will no longer be necessary in the future. In addition, all the licensee's obligations to withhold and declare withholding taxes will cease to apply.

5. Taxes on unforeseen profits (so-called windfall profit taxes)

With the Annual Tax Act (Jahressteuergesetz, JStG) 2022, the German government introduced a temporary **windfall profit tax** in the EU Energy Crisis Contribution Act. This affects certain companies operating in the oil, gas, coal or refinery sectors. These must pay a windfall profits tax for the first two (full) fiscal years beginning after 31 December 2021 (so-called taxation period). This amounts to 33% of the profit that is more than 20% above the average profit of the (full) fiscal years since 1 January 2018 until the beginning of the first (full) fiscal year starting after 31 December 2021 (first taxation period).

II. Case Law

1. Preliminary: prerequisites for a cross-border transfer of functions (exit tax)

On **16 March 2023,** the **Lower Saxony Tax Court (10 K 310/19)** was the first tax court to take a more detailed position on the criteria for a transfer of functions and clearly rejected a transfer of functions taxation. The ruling specifies some of the requirements for the taxation of a transfer of functions and brings more legal certainty for taxpayers. The tax audit assessed that a taxable transfer of functions had taken place because a production line of an operative GmbH in Germany was terminated and, while closure costs were reimbursed, no further consideration was paid. A related US company picked up the production. However, the tax court rejected a transfer of functions because neither assets nor other benefits and associated opportunities and risks had been transferred. In particular, the plaintiff had no independent power of disposal over its production volumes and no customer relationships of its own as they were already assigned to the "absorbing" company. Third parties would not have paid a fee for something they were already entitled to. Additionally, other advantages were not transferred because there was no sufficiently specific asset item at the plaintiff's level to be transferred. The ruling also clarifies that not every operational reduction of domestic functions and activities triggers a realisation of profits due to a transfer of functions.

The **appeal** to the **Federal Fiscal Court (BFH)** is pending under **file number I R 43/23**.

2. Arm's length interest on a loan

In its ruling of **22 February 2023 (I R 27/20)**, the **Federal Fiscal Court** (BFH) decided that the waiver of appropriate interest on a **loan** on a shareholder clearing account may constitute a hidden profit distribution.

With regard to the valuation of this hidden profit distribution, the court continues to adhere to its principles that the so-called "margin sharing principle" may be appropriate for measuring the appropriate interest rate if no other indications present themselves for estimating the interest rates customarily charged by third parties. In this context, the interest rate is to be estimated within the margin in which the credit interest rates customary in the banking industry statutes set the lower limit and the debit interest rates customary in the banking industry statutes set the upper limit. The Federal Fiscal Court does not see any contradiction with its more recent case law. There, it had seen the CUP as the primary method for determining arm's length interest rates.

In addition, the Federal Fiscal Court comments on the lack of collateralisation and emphasises that this is particularly important for determining an arm's length interest rate. In the Federal Fiscal Court's view, the tax court adhered to this by taking into account the insufficient collateralisation both in questioning the existence of a hidden profit distribution and in estimating the applicable interest rate.

3. Relationship between transfer pricing and customs law

In its ruling of **17 May 2022 (VIII R 2/19)** in the "**Hamamatsu**" case, the Federal Fiscal Court issued a very relevant decision on the interaction between transfer prices and customs: According to the Federal Fiscal Court, a subsequent **transfer pricing adjustment does not affect the customs value** if it is not certain at the time of the customs declaration whether and in which direction such an adjustment is to be made. It is questionable whether the ruling can also be applied to cases in which transfer pricing methods other than the profit split method are used.

4. Compatibility of surcharges with the freedom of establishment

In its **ruling of 13 October 2022 (C-431/21)**, the European Court of Justice (ECJ) declared the imposition of a **surcharge** pursuant to **Sec. 162 (4) of the German Fiscal Code (AO)** in the event of non-submission, late submission or insufficient transfer pricing documentation to be basically in line with the **freedom of establishment**.

The ECJ considers a difference in treatment to be justified by overriding reasons in the public interest. A compelling reason in the public interest is preserving the allocation of powers of taxation between the member states. The transfer pricing reporting requirements contribute to preventing the transfer of untaxed profits abroad by means of transactions not at arm's length. This also applies to the proportionality of the penalty of surcharges pursuant to Sec. 162 (4) AO. However, the statute is only necessary and thus proportionate if the fulfilment of the obligation is not associated with excessive administrative constraints for the taxpayer. The ECJ therefore called on the Bremen Tax Court to review the ordinance on documenting profit allocation (GAufzV) in the version applicable until 2017. The specifications of the record-keeping obligations pursuant to Sec. 90 (3) AO of the GaufzV could potentially give rise to excessive administrative constraint for the taxpayer. The Bremen Tax Court's decision is pending.

5. Permanent Establishments

a) Creating permanent establishments through activities of service and management companies

In its ruling of **23 March 2022 (III R 35/20)**, the **Federal Fiscal Court** decided on the requirements for **creating a permanent establishment** pursuant to Sec. 12 German Fiscal Code (AO). This concerns cases in which not the company itself but a service or management company acting on its behalf has a not merely temporary power of disposal over premises located in Germany.

According to the Federal Fiscal Court, the company's own power of disposal over a site is not required for creating a permanent establishment if the company's entrepreneurial activity is instead exercised by another company that has this power of disposal on site. For this, it is decisive whether there are identical management bodies, whether there is sustained supervision on the contractor's premises by the principal, and whether the company concerned has a certain spatial and temporal nexus on site. Merely providing instructions or monitoring measures from abroad is not sufficient. For taxpayers, the decision results in an increased risk of creating permanent establishments.

b) Creating a permanent establishment through a company-related locker or safe deposit box: fixed place of business through person-restricted utilization structures when providing services

In its ruling of **7 June 2023 (I R 47/20)**, the **Federal Fiscal Court** ruled that the provision of a specific locker or safe deposit box in the client's German premises suffices for the foreign service provider to have a (co-)power of disposal, i.e., for it to constitute a fixed place of business in Germany.

In this case, the service provider's own business activities are deemed to have a local nexus, so the service provider has a fixed place of business. It did not matter that the service provider's access was controlled and time-restricted and that the service provider could not impact the withdrawal of its power of disposal. It should also be emphasised that, according to the Federal Fiscal Court, the items stored in the locker do not have to be directly related to the provided service.

c) Surcharges for non-submission of, late submission of or insufficient transfer pricing documentation if a permanent establishment does not exist

In its ruling of **15 February 2022 (I B 55, 56/21 (AdV))**, the **Federal Fiscal Court** ruled on **surcharges pursuant to Sec. 162 (4) of the German Fiscal Code (AO)** in the event of non-submission of, late submission of or insufficient transfer pricing documentation in the absence of a declared permanent establishment.

If the taxpayer declares a foreign permanent establishment, it must also fulfil the cooperation obligations corresponding to its declaration. If the taxpayer does not comply with the request to submit transfer pricing documentation, the fact that the permanent establishment was neither substantiated nor credibly proven during the tax audit does not prevent the assessment of surcharges. The legal basis for the surcharges shall be the taxpayer's refusal to contribute to the factual clarification of its self-declared facts, not the actual existence of a permanent establishment abroad.

d) Attribution of assets to permanent establishments without personnel

The **Federal Fiscal Court** has serious doubts that permanent establishments without personnel per se cannot be assigned economic assets (Federal Fiscal Court dated **24 November 2021 (I B 44/21)**). The decision was issued in a proceeding regarding suspension of execution. In this proceeding, the Federal Fiscal Court was only required to assess if it had serious doubts, not if it was convinced that the taxation has been unlawful. The decision's background is the introduction of the Authorized OECD Approach in Sec. 1 (5) s. 3 German Foreign Tax Act (AStG) and its focus on significant people functions. According to the Federal Fiscal Court's view, the applicability of the principles for the attribution of assets in line with significant people functions is questionable in the case of permanent establishments without personnel. The Federal Fiscal Court also has doubts as to whether a permanent establishment, which is presumed to exist due to the existence of assets in the permanent establishment state, should not be attributed precisely these assets.

Furthermore, the Federal Fiscal Court says that neither the wording of Sec. 1 (5) s. 3 Foreign Tax Code nor prior rulings state that only significant people functions shall be used to attribute assets to permanent establishments.

e) Preliminary: no application of Sec. 1 (5) German Foreign Tax Act (AStG) and Ordinance on documenting profit allocation (GAufZV) in the absence of a business relationship between the head office and the permanent establishment (so-called dealing)

On **27 September 2022 (1 K 1595/20),** the **Nuremberg Tax Court** ruled that, in the absence of indications of a service relationship between the head office and the permanent establishment (so-called dealing), the Authorized OECD Approach as stipulated by Sec. 1 (5) s. 1 AStG in conjunction with Sec. 1 (1) s. 1 AStG shall not apply. Accordingly, the Ordinance on allocation of profits of permanent establishment (BsGaV) is irrelevant in these cases. These provisions only apply if there is a service relationship in the form of a dealing.

The **appeal** was admitted and is now pending before the **Federal Fiscal Court** under the **file number I R 45/22**.

In its ruling of **10 July 2023 (7 K 1938/22), the Munich Tax Court** also stated that the Authorized OECD Approach as stipulated in Sec. 1 (5) s. 1 AStG requires that there be a dealing within the meaning of Sec. 1 (4) s. 1 No. 1 AStG. This shall only be the case if the relationship between the head office and the permanent establishment has a certain **degree of significance**. The prerequisite for assuming a dealing is an actual activity, i.e., an economic transaction that represents an actual and identifiable event. The Authorized OECD Approach as stipulated in German tax law shall only be used as a rule for adjusting profits derived from dealings with related parties, not for determining profits overall. Consequently, it is irrelevant for the allocation of income and expenses from external transactions.

The **appeal** was also **allowed** in this case. A file number is not yet known.

6. Economic employer in the case of intra-group international assignment of employees

In its ruling of **4 November 2021 (VI R 22/19)**, the **Federal Fiscal Court** decided on the intra-group assignment of employees. A host company only becomes the economic employer if i) it bears the economic burden of the wages, ii) the employee's deployment in the company is in the company's interest and iii) the employee is integrated into the company's work process and is subject to its instructions. The mere reimbursement of wages is not sufficient. The economic bearing of an employment wage cannot be concluded solely from monthly paid lump sums, since, for example, the assumption of management activities by providing the employee under a service contract is conceivable. In this respect, the salary would then merely be a price component of this service.

7. Profit distributions by foreign corporations to controlling shareholders

In its ruling of **14 February 2022 (VIII R 32/19)**, the **Federal Fiscal Court** ruled on the inflow of capital gains from a controlling interest in a foreign corporation held by a shareholder subject to tax in Germany.

Whether the taxpayer has received profit shares from the foreign company depends on Sec. 20 (1) No. 1 German Income Tax Act (EStG) in conjunction with Sec. 11 (1) s. 1 EStG and, thus, the calendar year in which the profit distribution can be economically disposed of. In the case of controlling shareholders, the time of the shareholder resolution on the use of profits is generally to be assumed as the time of the inflow (and thus reception). However, this in itself is not sufficient. The distributing company must also be solvent and there must be no legal or factual obstacles to the shareholder's economic power to dispose of the distributed amount. For investments in foreign corporations, this means that, in addition to maturity and solvency, the shareholder's ability to dispose of the distribution under foreign law is also necessary for an assumption of inflow for German tax purposes.

8. Preliminary: no hidden profit distribution in the absence of a decline in assets, even without proof of the business reason for an acquisition; hidden profit distribution in the case of a loan with no prior intention of repayment

On **3 May 2022**, the **Düsseldorf Tax Court (Case No. 6 K 3388/16 K, F)** ruled that, in the absence of a decline in assets, there is no profit distribution within the meaning of Sec. 8 (3) German Corporate Tax Act (KStG). In the absence of a non-business sphere of the corporation, this is also the case if no evidence can be provided for any business reason for the acquisition of valuable items and jewellery at the level of the acquiring corporation. Instead, a business reason is always assumed. Furthermore, there is no decline in assets in the case of capitalisation and without a write-down to fair value.

In the same case, the Düsseldorf Tax Court also ruled, with no legal force, that a loan granted by a company to its shareholder (or a person close to them) already constitutes a hidden profit distribution at the time the loan is granted if there was no prior intention to repay the loan.

The ruling is subject to appeal to the **Federal Fiscal Court, file number XI R 27/22** (previously: I R 25/22).

III. Administrative orders

1. Update to the Administrative Principles on Transfer of Functions

On 26 October 2022, the new **Administrative Principles on Transfer of Functions (FVerlV 2022)** came into force. They tighten the 2008 regulation on transfer of functions. The Administrative Principles on Transfer of Functions apply to all transfers of functions completed in assessment periods beginning after 31 December 2021. The new regulation thus also applies to changes in a cross-border value chain that were started or disposed of before 1 January 2022.

The definition of a transfer of functions has been tightened. Now, even the partial transfer or assignment of a function is sufficient to trigger a profit-realizing transfer of functions and, therefore, exit tax. Accordingly, it shall be sufficient for the assumption of a transfer of functions if the acquiring company already performs the function but is able to expand the function due to the transfer. Meanwhile, the exception for duplicating functions (no restriction of the function related to the transfer at the "transferring" company within five years) remains in place. However, the previously applicable de minimis limit of EUR 1 million has been deleted without replacement. Other previously existing escape clauses have been restricted.

In principle, the new Administrative Principles on Transfer of Functions assumes a perpetual annuity for valuation purposes. Taxpayers must prove reasons for a shorter capitalisation period; previously, a prima facie case was sufficient.

2. Administrative Principles Governing Transfer Pricing 2023

On 6 June 2023, the German tax authorities published the Administrative Principles Governing Transfer Pricing 2023, a revised version of their principles for income adjustments pursuant to Sec. 1 German Foreign Tax Act (AStG), which governs the arm's length principle in German domestic law. The comprehensive circular, which deals with income adjustments and the application of the international arm's length principle, includes comments on the revised transfer of functions regulation. In particular, the Federal Ministry of Finance comments on the determination and relocation of a function and the valuation of the so-called transfer package that is assumed for transfer of functions cases. In particular, the examples contained in the Administrative Principles Governing Transfer Pricing 2023 underline the tax authorities' trend toward the ongoing atomization of the concept of function.

In addition, the Federal Fiscal Court's case law on the determination of arm's length interest rates for group loans is referred to regarding intra-group financing. It is explicitly recognised that unsecured loans can also be at arm's length. It is also recognized that the interest rate of an unsecured loan may include risk compensation.

With the exception of the regulations on the transfer of functions, the Administrative Principles Governing Transfer Pricing 2023 are to be applied to all open cases. They shall be applied to transfers of functions that are realized after 31 December 2021. The regulations of the Administrative Principles on Transfer of Functions dated 13 October 2010 shall apply to transfers of functions that were realized before 1 January 2022. The previous version of the administrative principles and the non-application decrees regarding the Federal Fiscal Court's rulings of 17 December 2014 (I R 23/13) and 24 June 2015 (I R 29/14) have been repealed.

3. Federal Ministry of Finance circular on tax deduction for software contract development dated 2 August 2022

As a result of an amendment to the German Copyright Act (UrhG) effective 7 June 2021, certain provisions on the protection of moral rights (in particular Sec. 32a UrhG (so-called claim to subsequent remuneration) and Sec. 41 UrhG (so-called right of recall)) no longer apply to copyrights in computer programs.

However, copyrights in computer programs remain non-transferable under civil law (Sec. 29 (1) UrhG). On 2 August 2022, the **Federal Ministry of Finance (BMF)** issued a circular on questions of **tax deduction for remuneration for cross-border software contract development services**. For payments received by or accrued to foreign software developers after 6 June 2022, the circular now defines binding delimitation criteria for examining whether the payment is subject to tax deduction in Germany pursuant to Sec. 50a (1) No. 3 German Income Tax Act (EStG). Accordingly, as a result of the amendment to the Copyright Act, domestic payment debtors are no longer required to withhold tax if the software development service constitutes an economic purchase of rights. In the Federal Ministry of Finance's opinion, however, an economic purchase of rights requires that the agreement on the provision of software development services provide for the granting of comprehensive, exclusive and irrevocable rights of use and exploitation to the software for an unlimited period of time. The circular does not make any explicit statement on the question of whether payments are subject to tax deductions that accrued to foreign software developers prior to 7 June 2021 under the copyright law applicable until then. Domestic taxpayers who have made payments to foreign software developers in the period prior to 7 June 2021 should check whether there is a tax withholding obligation for these payments in the individual case. In addition, existing agreements should be reviewed to determine whether the granting of comprehensive, exclusive and irrevocable rights of use and exploitation to the software, as required by the circular, is expressed sufficiently clearly in the text of the agreement.

4. Federal Ministry of Finance circular on the significance of the OECD Model Commentary for the interpretation of double tax treaties

On 19 April 2023, the **Federal Ministry of Finance** published a circular on the **significance of the OECD Model Commentary for the interpretation of double tax treaties**.

Although its first paragraphs suggest the contrary, the circular goes against long-standing case law of the Federal Fiscal Court. The Federal Ministry of Finance bases its view on a dynamic treaty interpretation and assumes that the OECD commentary is to be taken into account in the interpretation of double tax treaties in the version valid at the time of application. The Federal Fiscal Court, on the other hand, has consistently adopted a static interpretation where only the date that the agreement is concluded is relevant.

In addition, the Federal Ministry of Finance is of the opinion that the OECD Model Commentary is to be regarded as a rebuttable indication of the national practice of the OECD member states in interpreting the provisions of their double tax treaties that correspond to the OECD Model Convention. In this context, the OECD member states' observations contained therein would have to be taken into account. If an OECD member state has not submitted any observations against the commentary, it would be assumed that it shares the view expressed in the commentary.

5. Draft of a current Federal Ministry of Finance circular on the principles for the application of the Foreign Tax Code

On 19 July 2023, the **Federal Ministry of Finance** sent the draft of a current circular on the **principles for the application of the German Foreign Tax Code (AStG)** to certain associations and requested comments by 4 September 2023. This is intended to revise and replace the current circular, which was fundamentally revised last in 2004. The revisions in particular take into account the changes resulting from implementing the EU's Anti-Tax Avoidance Directive into German law. The circular primarily concerns the administrative interpretation of the exit taxation (sec. 6 AstG) and the controlled foreign company (CFC) taxation (Sec. 7 et seq. AStG). With regard to exit taxation, the main changes relate to the (personal) scope of application, the return rule under Sec. 6 (3) AstG and tax deferral. Statements on the addition of indirect shareholdings and on control are the main point of emphasis of the section on CFC rules. This shall reflect changes in the definition of "domestic control" in Sec. 7 AStG and the elimination of certain profit inclusion rules in the case of multilevel shareholding chains (Sec. 14 of the old version of the AStG). In addition, the section on the taxation of the addition of profits contains explanations on the new asset catalogue of Sec. 8 (1) AStG, the principal purpose test in Sec. 8 (2-4) AStG, the switchover clause of Sec. 20 (2) AStG in the case of permanent establishments and the stricter CFC rules pursuant to Sec. 9 Tax Haven Defense Act. In addition, comments on family foundations under Sec. 15 AStG, which was fundamentally revised by the 2013 Administrative Assistance Directive Implementation Act, were included in the draft circular.

6. Factual agreements – application in cross-border situations

In its circular dated 23 June 2023, the **Federal Ministry of Finance** supplements its circular dated 30 July 2008 (last supplemented on 15 April 2019) on the principles of "**factual agreement**." Under the principles of factual agreement, tax audit findings can be legally secured by mutual agreement with the German tax authorities. According to the new circular, the principles of factual agreement should only be used with restraint in cross-border situations. Reference is made to the existing instruments of international administrative cooperation, e.g., the possibility of a cross-border tax audit. In addition, if a factual agreement is concluded in cross-border cases, the factual agreement should also be signed by the top management of the group (even if based abroad). This makes achieving the factual agreement in cross-border cases more difficult.

7. Draft Federal Ministry of Finance circular on the prohibition of deducting operating expenses in the event of hybrid mismatches (Sec. 4k German Income Tax Act (EStG))

In a circular dated 13 July 2023, the Federal Ministry of Finance sent a **draft** circular on the **prohibition of deducting operating expenses in the case of hybrid mismatches pursuant to Sec. 4k EStG** to certain associations and requested comments. Sec. 4k EStG was introduced by the Anti-Tax Avoidance Directive Implementation Act (ATADUmsG) of 25 June 2021 to neutralise hybrid mismatches. The extensive circular contains a large number of practical pointers, examples and significant interpretations of the statute. The draft misses, however, a clear statement on whether Sec. 4k EStG applies with regard to the US GILTI taxation.

IV. International developments

1. ATAD 3: EU Directive to prevent the use of letter box companies for tax abuse ("Unshell-Directive")

In December 2021, the **EU Commission** published a **proposal for a directive to** prevent the use of **shell entities** for tax abuse (ATAD 3). On 17 January 2023, the EU Parliament adopted a slightly modified draft directive. The proposal provides for a two-step substance test for EU resident companies.

If a company does not meet the minimum substance requirements in its Member State of residence, the company is to be denied access to the benefits of EU Directives and double tax treaties. The draft directive also contains severe sanctions of 2% of annual revenues in the relevant tax year if the substance requirements have not been met. In the event of a false declaration, a penalty of at least 4% of the entity's revenue applies. If a company has only low or no revenues, the penalty is to be calculated based on the total amount of assets.

A decision by the Council of the European Union is pending.

2. DEBRA: EU Commission proposal to reduce the imbalance in the tax treatment of equity and debt

On 11 May 2022, the EU Commission published a draft directive on the "Debt-Equity Bias Reduction Allowance Directive" (DEBRA). The aim of the directive is to offset the tax advantages of debt over equity.

Essentially, this will involve introducing **a tax allowance on equity**. This allowance is to be calculated based on the difference between the tax equity of the current tax year and the equity at the end of the previous tax year. It is then increased by the 10-year risk-free interest rate for the respective currency, multiplied by a risk premium and is deductible for 10 consecutive tax years up to a limit of 30% of EBITDA. In addition, the draft directive provides for a new limitation on the deductibility of interest on borrowed capital and various measures to combat abuse. The proposal provides that member states must implement the directive by 31 December 2023. The application of the rules should start from 2024. Member states that already apply an allowance on equity according to their national law may postpone the application of the rules for up to 10 years.

However, at a meeting of the EU Economic and Financial Affairs Council on 6 December 2022, the EU member states decided to postpone deliberations on the draft DEBRA. This was announced by the German government in its response (20/5119) to an inquiry from a parliamentary group.

3. OECD Manual on the Implementation of Mutual Agreement Procedures and Advance Pricing Agreements

On 1 February 2023, the OECD "Forum on Tax Administration" published the "**Manual on the Handling of Multilateral Mutual Agreement Procedures and Advance Pricing Agreements (MoMA)**." The aim is to create more transparency and legal certainty between countries.

On the one hand, the OECD comments on the legal basis for implementing mutual agreement procedures and APAs (e.g., on the definition of a mutual agreement case, the legal basis and the requirements for an initiation request). On the other hand, it also deals with practical aspects of the proceedings. Among other things, it explains appropriate approaches for consultants, authorities and the involvement of the taxpayer in the proceedings. In addition, the MoMA contains sample cases on transfer pricing issues and on the determination of permanent establishment profits.

In Germany, the MoMA is not legally binding. It only serves as an interpretation aid for taxpayers and the tax authorities.

4. EU Foreign Subsidies Regulation

On 12 January 2023, the **EU regulation** on foreign subsidies distorting the internal market entered into force. It is applicable **as of 12 July 2023**. The objective of the regulation is to establish control mechanisms for subsidies granted by countries outside the internal market (so-called third countries) to companies operating in the internal market so that a **level playing field is** created. The regulation is intended to close a regulatory gap. While subsidies granted by third countries have hardly been examined so far, subsidies granted by member states are subject to EU state aid control.

Three new control mechanisms were created.

- M&A transactions: new review process with prohibition of execution for mergers
- Procurement procedures: a notification and clearance system for the procurement system to review third-party subsidies under procurement law
- General abuse oversight of foreign subsidies by the commission

For both merger and public procurement control, the regulation provides for the **possibility of validating** legal transactions that have been executed prematurely (i.e., before its notification). In the case of legal transactions that do not meet the regulation's notification thresholds, a **prohibition of execution** or a pending ineffectiveness applies as of when the commission orders the notification obligation. The commission may also impose a **fine for** violations of the notification requirements. In addition, it may order the filing of a notification.

5. EU Commission: proposed BEFIT Directive

On 12 September 2023, the **EU Commission** published several proposals for directives to harmonise taxation in the EU, including a new directive "**Business in Europe: Framework for Income Taxation**" (BEFIT). The so-called BEFIT Directive replaces the EU's previous efforts to introduce a Common Consolidated Corporate Tax Base (CCCTB). According to the EU Commission's proposal, the directive would replace the various methods used by member states to determine the tax base for groups of companies with total annual revenues of more than EUR 750 million. The principles of the directive would also apply to groups headquartered outside the EU that exceed certain thresholds.

According to the EU Commission's proposal, the directive is to be transposed into domestic law by 1 January 2028 and the provisions are to be applied as of 1 July 2028. However, it must be emphasised that this is so far only a proposal by the EU Commission, which would have to be adopted unanimously by the EU member states.

6. EU Commission: proposed Transfer Pricing Directive

On 12 September 2023, the **EU Commission** published several proposals for directives to harmonize taxation in the EU, including one for a **Transfer Pricing Directive**. The proposed directive would implement the arm's length principle into European law. In addition to explicitly emphasizing the OECD Transfer Pricing Guidelines as an interpretative tool for arm's length taxation, the proposed directive contains rules on corresponding adjustments and year-end adjustments.

According to the EU Commission's proposal, the directive is to be implemented into domestic law by 31 December 2025 and the provisions are to be applied as of January 2026. However, it must be emphasized that this is so far only a proposal by the EU Commission, which would have to be adopted unanimously by the EU member states.

7. OECD Pillar 1 & 2 – status of international discussion

a) Update to Pillar 1

In particular, the OECD still aims to publish a multilateral convention (MLC) for the implementation of Amount A (= reallocation of residual profits) in 2023 and to organize a signing ceremony. The goal is for this MLC to enter into force in 2025. The Inclusive Framework member countries that have signed up to the Outcome Statement will also refrain from imposing new unilateral measures such as a digital service tax in 2024 or until the MLC enters into force. However, this commitment is subject to at least 30 countries responsible for 60% of the ultimate parent companies in the scope of Amount A signing the MLC by the end of 2023. The future of Amount A still depends on the US in particular, as various US groups will fall under the scope of Amount A. According to current reports, the US intends to sign the treaty but not to ratify it.

In addition, the OECD has published a further consultation paper on Amount B of Pillar 1. Amount B is intended to create a simplified application of the arm's length principle to certain distribution activities. Although agreement has already been reached on many points, further work is intended to define the scope of application and the pricing mechanism. Interested members of the public were able to submit comments until 1 September 2023. The final work result on Amount B is ultimately to be integrated into the OECD Transfer Pricing Guidelines.

b) Update to Pillar 2

Over the last two years, the OECD has delivered the Model Rules, the Commentary and the first Administrative Guidance on Pillar 2. The first publication of the Subject-to-Tax Rule (STTR), including implementation rules, followed. In addition, there was the second package of administrative guidance, which focuses on the Substance-based Income Exclusion and the QDMTT. In addition, there were also updates on two safe harbours, namely (i) the permanent QDMTT safe harbour and (ii) the transitional UTPR safe harbour. The UTPR safe harbour will be of particular benefit to US corporations and their foreign subsidiaries, as the implementation of the GloBE Rules in the US is still not expected in the foreseeable future. Last but not least, the OECD also published a comprehensive document with a kind of template for the GloBE Information Return and related explanations.

While the OECD will continuously develop and publish additional guidance on Pillar 2, the implementation into national law is progressing in many countries. Accordingly, taxpayers in many places can expect that national regulations on Pillar 2 or, more precisely, the Income Inclusion Rule will apply for the first time in the 2024 assessment period.

V. Expected developments and announced legislative changes

1. Minimum Tax Directive Implementation Act

The German government is planning to introduce a law to ensure global minimum taxation. According to the draft version of 16 August 2023, the law to implement Council Directive (EU) 2022/2523 to ensure global minimum taxation and further accompanying measures is to introduce, in particular, the so-called Minimum Tax Act (MinStG). The model for this is, on the one hand, the OECD GloBE Model Rules (so-called Pillar 2) and, on the other hand, the EU Pillar 2 Directive based on them (Directive (EU) 2022/2523). The EU Pillar 2 Directive is to be implemented into national law by 31 December 2023.

The MinStG contains the introduction of the Income Inclusion Rule (IIR, "**primary top-up tax rule**") from 2024, the UTPR ("**secondary top-up tax rule**") from 2025, and the DMTT ("**national top-up tax**") from 2024. It remains to be seen whether and to what extent the ongoing OECD publications (especially in the form of the administrative guidance) will still be incorporated into the national implementation law.

a) Controlled Foreign Company (CFC) taxation

During the introduction of the Minimum Tax Act, the low taxation threshold for the purposes of CFC taxation in Sec. 8 (5) German Foreign Tax Act (AStG) is to be reduced to 15% according to the current draft.

b) Licence barrier

During the introduction of the Minimum Tax Act, the low tax threshold for the purposes of the so-called licence barrier (Sec. 4j German Income Tax Act (EStG)) is to be reduced to 15% according to the current draft.

2. Increased permanent establishment risk due to home offices after the expiration of COVID-19 rules

As a result of the increasing establishment of professional practice in the home office, the risk of creating a permanent establishment is also increasing.

During the COVID-19 pandemic, the OECD drew up guidelines on the handling of home offices. According to this guidance, anyone who worked in a home office on government orders to contain the pandemic did not establish a permanent establishment. Prior to the COVID-19 pandemic, the view was that, if the employee worked almost exclusively in the home office, the employer's power of disposal was to be affirmed; consequently, a permanent establishment was assumed. This was relativised if the employer did not require permanent use and the employee had a workplace in the company, regardless of its actual use. The characteristic of a "certain duration" was also important. According to the OECD Model Commentary, this characteristic is fulfilled for a period of six months. The Federal Fiscal Court also follows this time benchmark in its case law. However, there is no specific legal regulation.

A detailed discussion of the permanent establishment issue in home office cases can be found in the presentation by Dr. Stephan Schnorberger at the 2023 Global Transfer Pricing Conference and can be read in the paper "Transfer Pricing and Remote Work" published afterwards.

3. Draft "Growth Opportunities Act," which impacts, among other things, the scope and amount of intra-group interest, retention periods following reorganizations, and reporting requirements for domestic tax arrangements

On 30 August 2023, the German Cabinet approved a draft bill to strengthen growth opportunities, investment and innovation, and tax simplification and tax fairness (the so-called Growth Opportunities Act).

The interest barrier pursuant to Sec. 4h German Income Tax Act (EStG) is to be amended, among other things, so that the so-called standalone clause (Sec. 4h (2) s. 1 lit. b EStG) is aligned with the requirements of the ATAD. Accordingly, the standalone clause should only apply if the taxpayer is not related to a person within the meaning of Sec. 1 (2) German Foreign Tax Act (AStG) and does not have a permanent establishment outside the taxpayer's country of residence, habitual abode, domicile or management. The new interest barrier rules are to be applied for the first time to fiscal years that begin after the date of the decision on the law and do not end before 1 January 2024.

Furthermore, an interest rate barrier is to be introduced in Sec. 4l EStG, according to which interest expenses between related parties are not deductible if the interest rate is higher than the maximum rate (two percentage points above the base rate according to Sec. 247 German Civil Code (BGB)). Exceptions apply in cases where proof of the higher refinancing interest rate of the creditor and the ultimate parent company is provided or if the creditor carries out a significant economic activity in the country of domicile or management.

An application to exercise the option for corporate income taxation pursuant to Sec. 1a German Corporate Tax Act (KStG) may be made within one month of the formation or change of legal form. The option for corporate income taxation shall apply to all partnerships. In addition, the fiction of distribution ceases to apply as soon as a payment of the profit shares can be demanded.

In addition, the post-divestiture lock-up for spin-offs (Sec. 15 (2) German Conversion Tax Act (UmwStG)) will be revised. According to Sec. 15 (2) s. 2 UmwStG – draft, the book value shall not be continued if a sale to outside persons is prepared by means of a spin-off (previously only completed). This preparation requires a sale or a concrete (not only hypothetically considered) intention to sell and the actual sale of at least one share within five years.

In addition, the introduction of a reporting obligation for domestic tax arrangements is planned in secs. 138l-138n German Fiscal Code (AO), which are comparable to the DAC6 regulations in Sec. 138d-138h AO. The prerequisites are that there is no cross-border tax structuring as defined in Sec. 138d (2) AO, the tax advantage is one of the main benefits (so-called main benefit test) and one of the (specific) characteristics listed therein has been met.

4. Investment premium for climate protection and digitization / super depreciation

The investment premium for climate protection and digitization (also known as "super depreciation") planned in the German government's coalition agreement for 2022 will probably not be introduced in 2023 either. The "super depreciation" provides for taxpayers to be able to deduct a share of the costs of goods purchased or manufactured for climate protection and digitization from their taxable profits. However, due to the supply shortages and energy crisis, the German federal minister of finance has decided not to propose the corresponding bill in 2023, either. When and in what specific form this super depreciation will be introduced remains open for the time being and will probably depend in particular on the general economic situation.

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