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# Double standards for the taxation of intra-group financing

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The German Federal Ministry of Finance has published a draft law for the implementation of the EU Anti-Tax Avoidance Directive (ATAD Implementation Act) on 10 December 2019. This draft includes inter alia a new section 1a German Foreign Tax Act (Außensteuergesetz – AStG) on cross-border intra-group financing. The implementation of this proposal would further increase the legal uncertainty in this area.

The German tax authorities generally only acknowledge intra-group loans and other debt instruments without adjustments if these are very clearly shown to have been granted on arm's length terms. There is, however, no clear standard for the arm's length principle in this area.

### Existing law

There are no concrete legal requirements on intra-group financing and the German Federal Tax Court (Bundesfinanzhof – BFH) has not been able or willing to develop consistent case law in this field. The Federal Tax Court largely abandoned its previous case law on intra-group financing in a fundamental judgement on 27 February 2019, (file reference I R 73/16) without developing a clear new line. The OECD has published a detailed transfer pricing guidance on financial transaction on 11 February 2020 (OECD-guidance).

### Structure of the proposed section 1a AStG-draft

Under section 1a AStG-draft tax expenses arising from a cross-border financing relationship within a multinational group need to be reduced if they are not in line with the arm's length standard as defined in this provision.

The proposed section 1a AStG-draft is partly based on the requirements for intra-group financing which have been discussed at the OECD level and have now been implemented in the OECD-guidance. In brief, the proposed 1a AStG-draft stipulates:

- Financing is not arm's length if the company would not have been able to service the debt (interest and amortisation) for the entire term of this financing relationship from the outset. Conversely, financing should only be arm's length if the company needs the funds economically and uses them for its operations. Similar specifications can be found in numbers 10.13. and 10.37. of the OECD-guidance.

- The interest rate at which the entire multinational group of companies can finance itself is to be regarded as a rebuttable reference for the interest rate at which the individual company can finance itself. The OECD-guidance contains a similar method, whereupon the credit rating of the individual company can under certain circumstances be based on the credit rating of the entire group (numbers 10.81. and 10.82. OECD-guidance).

- The arrangement or passing on of financing relationships within a multinational group of companies should regularly be a low-value and low-risk service, and the remuneration for such services should be limited to the risk-free interest rate corresponding to the rate of government bonds of the highest credit rating with similar maturities. It is unclear how this requirement should be implemented in the current interest rate environment with partly negative interest rates for government bonds. The OECD-guidance contains a much less stringent reference to government bonds to determine the "risk free rate of return" (section F.1. OECD-guidance).

## Scope of the draft

The wording of section 1a AStG-draft only refers to interest expenses. It should apparently not apply to possible adjustments of the lender's income and is thus not a comprehensive regulation of the arm's length principle in financing relationships. The proposed provision basically only covers 50% of all cases of intra-group financing and primarily applies to inbound financing, i.e. the financing of German companies by group companies in other states. Section 1a AStG-draft also constitutes another treaty override because its standards would apply regardless of a double tax convention.

Section 1a AStG-draft is another one sided adjustment rule for the benefit of the tax authorities and not a guideline for the tax treatment of cross-border financing to which taxpayers and tax authorities can equally refer. From the taxpayers' point of view, section 1a AStG-draft would further increase the legal uncertainty in the area of intra-group financing.

## Tax policy implications

In terms of policy, the introduction of section 1a AStG-draft would be a step in the wrong direction. There is no reason that the tax authorities can adjust interest expenses in the case of inbound financing based on the standards of section 1a AStG-draft, whereas the taxpayers should not be able to rely on these standards if they would work in their favour in outbound cases.

Due to a recent ruling by the German Federal Tax Court (file reference I R 73/16) it is unclear whether taxpayers can justify low interest rates in case of outbound financing with the argument that a foreign subsidiary has the financial backing of the group. The reference in section 1a AStG-draft to the interest rate at which the entire group could obtain financing only applies to cases of inbound financing.

- For instance, in case a German subsidiary receives a loan from its foreign parent, the tax authorities could reduce an interest rate based on the subsidiary's poor credit rating with reference to Section 1a AStG-draft by taking into account the credit rating of the entire group. In theory, the subsidiary could demonstrate that the higher interest rate is arm's length. But there is currently no binding general standard for an arm's length interest rate, so that this possibility may be of little practical relevance.

- Conversely, the tax authorities could, with reference to the Federal Tax Court's case law, increase the interest income from the financing of a foreign subsidiary if, due to the group's credit rating, an interest rate was agreed which is lower than an interest rate based on the

foreign subsidiary's individual credit rating. The introduction of section 1a AStG-draft would in many cases result in double taxation. Due to the treaty override, Germany would not be bound by the standards of double tax conventions and an increase in income in Germany would in many cases not be balanced by a corresponding correction in the other state.

## Incoherency with EU and constitutional law

Due to its one-sidedness section 1a AStG-draft would probably also violate EU and constitutional law.

- Section 1a AStG-draft is likely to violate the European freedom of establishment. In its Hornbach judgment of 1 May 2018 (C-382/16), the European Court of Justice (ECJ) decided, that a rule such as Section 1 AStG on the arm's length principle in cross-border cases is generally compatible with the freedom of establishment because its purpose is to ensure a balanced distribution of taxation powers between the member states. This justification may not apply to section 1a AStG-draft, because this provision does not serve the balanced distribution of taxation powers between the member states, but is intended to unilaterally ensure tax revenue in Germany's favour.
- In addition, Section 1a AstG-draft is likely to violate the principle of consistency, which derives from the constitutional principle of equality. The legislator is bound by its own system to ensure an equal taxation. Section 1a AStG-draft would in favour of the tax authorities unilaterally intervene in the system of the arm's length standard without an apparent justification.

## Summary

Section 1a AStG-draft is a one-sided regulation at the expense of taxpayers. Its introduction would result in more legal uncertainty in the area of intra-group financing. Against this background, it is doubtful whether section 1a AStG-draft is compatible with EU and constitutional law.

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