THE IMPLEMENTATION OF THE D.A.C.6 E.U. DIRECTIVE IN GERMANY

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INTRODUCTION

The E.U. Directive 2018/822 of 25 May 2018 ("Directive")[1] introduced a new reporting obligation for potentially aggressive cross-border tax arrangements in order to provide the tax authorities with information about potentially aggressive tax arrangements.

The Directive was implemented into German law by the inclusion of several sections (sec. 138d to 138k) into the German General Tax Code (*Abgabenordnung*, or "A.O.") in 2019, effective as of July 1, 2020, with an additional retroactive obligation to include all open tax arrangements that were set up from June 24, 2018.[2] Germany did not elect optional postponement of the D.A.C.6 implementation due to the COVID-19 crisis.

In Germany, a political discussion of plans for such reporting obligations dates back to 2007. However, in those days, the plans[3] had not been pursued further because of heavy criticism in the tax community. In 2014 a similar proposal arose in the Federal Council.[4] However, it was never enacted the implementation of Directive.[5]

German tax authorities have not yet published the final version of the administrative decree on D.A.C.6. The latest official draft version is dated July 14, 2020 (the "Draft Decree").[6]

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1 Council Directive (E.U.) 2018/822 of 25 May 2018.

2 Law on the introduction of an obligation to report cross border tax arrangements ("*Gesetz zur Einführung einer Pflicht zur Mitteilung grenzüberschreitender Steuergestaltungen*"), the "D.A.C.6 Implementation Law", of 21 December 2019, Federal Law Gazette 2019 I, p. 2875 ff.

3 Draft of a Bill of law of 25 June 2007. Said bill of law has not been publicly released. It can be downloaded here.

4 Resolution of the Bundesrat on combating international tax arrangements, in the preliminary preparatory working papers of the Federal Council ("*Bundesrats-Drucksache*") of 23 May 2014, 205/14, p. 2 *et seq*. The Federal Council ("*Bundesrat*") is one of the two legislative bodies in Germany. It represents the German Federal States.

5 Details are provided by Johanna Hey, memorandum on the constitutionality of the introduction of a general reporting obligation for tax arrangements ("*Gutachten zur Verfassungsmäßigkeit der Einführung einer allgemeinen Anzeigepflicht für Steuergestaltungen*") of February 2018, p. 5 *et seq*.

6 Draft version of the administrative decree on the application of the provisions on the reporting obligation for cross border tax arrangements ("*Entwurf eines BMF-Schreibens betreffend die Anwendung der Vorschriften über die Pflicht zur Mitteilung grenzüberschreitender Steuerverwaltungen*") of 14 July 2020, IV A 3 – S 0304/19/10006: 008.

SCOPE OF THE REPORTING REQUIREMENT

Covered Taxes

The reporting requirement is limited to tax arrangements regarding German and E.U. taxes. U.S. taxes or the taxes of non-E.U. Member States are not covered.

Not all kinds of taxes trigger a reporting obligation. However, individual and corporate income taxes[7] and trade taxes[8] can lead to cross-border arrangements that are covered. In addition, real estate transfer tax,[9] land tax,[10] and inheritance and gift tax can lead to a cross-border arrangement that is covered by the Directive.[11]

On the other hand, tax effects resulting from V.A.T.[12] or customs, E.U. harmonized excise duties or social security contributions or other fees are excluded and cannot trigger a D.A.C.6 reporting obligation.

Tax Arrangements

The definition of the term "tax arrangements" in the Draft Decree is abstract and broad. For that reason, it has limited use in practice. A tax arrangement is defined as a deliberate process of creation that changes factual and/or legal events with tax relevance through transactions, arrangements, actions, operations, agreements, commitments, obligations or similar events.[13]

At least of a certain practical use is the additional statement that a deliberate and active induction or change of a structure, process or situation is required.[14] In principle, this should prevent an intentional deferral of action until a statutory time period passes from being a tax arrangement.[15] A case in point is the deferral of dividend declaration until after the passing of the minimum holding period for applying the participation exemption for dividend income.[16]

Nonetheless, the definition of tax arrangement does not provide much help in causing a cross-border arrangement from being reportable.

Cross-Border Element

The tax arrangement must be a cross-border tax arrangement. This cross-border element requires that

7 *Einkommensteuer or Körperschaftsteuer.*

8 *Gewerbesteuer.*

9 *Grunderwerbsteuer.*

10 *Grundsteuer.*

11 *Erbschaft- und Schenkungsteuer.*

12 *Umsatzsteuer.*

13 Draft Decree, no. 9.

14 *Id.*

15 *Id.*

16 Such as Art. 10 (3) a) of the double tax treaty between Germany and the U.S.A. of July 4, 2008.

- either more than one E.U. member state are affected by the tax arrangement, or
- at least one E.U. member state and one or more countries in nonmember states, such as the U.S. are affected by the arrangement.

Hence, even cross-border tax arrangement without German nexus might be reportable in Germany if not reported already in another competent E.U. jurisdiction by the same or another intermediary.[17]

In addition, one of five alternative prerequisites must be met:

- The first alternative[18] is that not all of the participants in the tax arrangement are resident for tax purposes in the same jurisdiction. Hence, this alternative would not be met if all participants are tax resident in the U.S.A. The one-country exception is not limited Germany.
- The second alternative[19] is that one or more of the participants in the tax arrangement is simultaneously tax resident in more than one jurisdiction. If the U.S. consider U.S. citizens as U.S. tax residents, while Germany considers somebody as German tax resident if that person has his domicile or habitual abroad in Germany, this alternative should be met. The same should apply if, for example, a corporation is considered U.S. tax resident because it is formed under the laws of a State of the U.S. such as Delaware, while it is also considered German tax resident as its effective place of management is in Germany.
- The third alternative[20] is met if one or more participants in the tax arrangement carries on a business in another jurisdiction through a permanent establishment and the tax arrangement relates to the business of that permanent establishment. This would be the case of a U.S. corporation with German or Dutch permanent establishment, where the tax arrangement relates to German or Dutch activity. If, however, the activity of the U.S. corporation relates solely to a U.K. permanent establishment, this alternative is not met if not relevant to the Dutch or German permanent establishment. No E.U. member state is affected by the tax arrangement between the U.S. corporation and its U.K. permanent establishment.
- The fourth alternative[21] is met if one or more participants in the tax arrangement carries on an activity in another jurisdiction without being tax resident or creating a permanent establishment in that jurisdiction. A typical case is the real estate investment of a foreign investor in Germany. In order to limit the extent of that alternative, the Draft Decree requires that such activity in the other jurisdiction must be substantial as to taxes and provides a respective example.[22]

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[17] See below under 6.3 for details on the measures to exclude double reporting and under 7. For details on the interaction between several intermediaries.

[18] Sec. 138d (2) no. 2 lit. a) AO.

[19] Sec. 138d (2) no. 2 lit. b) AO.

[20] Sec. 138d (2) no. 2 lit. c) AO.

[21] Sec. 138d (2) no. 2 lit. d) AO.

[22] Draft Decree, no. 36.

In the example, a German corporation X purchases German real estate from a German corporation Y. Both are tax residents in Germany. X provides digital services to customers in Germany and Italy. The real estate purchase as potential tax arrangement has no connection with the digital services to Italian customers. Thus, the Italian activity is not substantial as to taxes under the purely German tax arrangement. Hence, there is no cross-border tax arrangement.

- The fifth alternative[23] relates to tax arrangements that have possible impact on the European automatic exchange of information (roughly this can be compared to F.A.T.C.A.) or the identification of beneficial ownership (money laundering related concept).

The Intermediary

If there is a cross-border tax arrangement on reportable taxes, the further analysis refers to the intermediary. The intermediary can be described as the master mind behind the tax arrangement and the person generally in charge of the reporting of a reportable tax arrangement. Hence, it is also the primary person, who must assess whether there is a reportable tax arrangement.

The intermediary is defined by reference to certain activities with respect to a reportable cross-border tax arrangement. It is the person who designs, markets, organizes or makes available for implementation or manages the implementation of a reportable cross-border tax arrangement. Hence, many professionals can qualify as intermediary, such as lawyers, tax advisors, banks, investment managers or insurance companies. This list is not exhaustive.

For German D.A.C.6 reporting obligations, German tax residents, E.U. tax residents or even third country tax residents, such as a U.S. tax resident, can qualify as intermediary.

The Draft Decree provides certain guidance and relief as to each of the activities that makes a person an intermediary. For example, a person does not design a tax arrangement when it merely assesses a tax arrangement planned, designed or developed by the relevant taxpayer on its own or by a third party.[24] Hence, an expert opinion on the tax consequences of a pre-designed tax arrangement should not trigger intermediary status on the expert.[25] Furthermore, the mere abstract reproduction of the wording (*i.e.* of the law and the presentation of the administrative decrees, the case law of the (tax) courts) should also not trigger the intermediary status.[26]

There are also cases that do not use an intermediary, such as a fact pattern involving a mere inhouse restructuring by the relevant taxpayer planned for and implemented by itself. In such case, the relevant taxpayer must fulfills the tasks normally assigned to the intermediary. It must analyze whether reportable cross-border tax arrangement results from the restructure and must report the arrangement to the competent tax authority.

[23] Sec. 138d (2) no. 2 lit. e) AO.

[24] Draft Decree, no. 55.

[25] *Id.*

[26] *Id.*

The Hallmarks

In accordance with the Directive, the German implementation distinguishes two types of Hallmarks which must be realized in order to give rise to a D.A.C.6 reporting requirement. On one hand, there are Hallmarks for which one of the main benefits of the arrangement is the reduction of taxes (so-called "main benefit test" ("M.B.T.")). On the other hand, there are certain Hallmarks that do not require a finding under the M.B.T.[27]

The M.B.T. is required for those Hallmarks that are not necessarily viewed as potentially aggressive tax arrangements in appropriate fact patterns. The M.B.T. of sec. 138d (2) no. 3 lit. a) A.O., thus, requires in addition that from the perspective of a prudent observer and in an overall assessment at least one of the main benefits of an arrangement is the tax advantage that results from the transaction. In this respect, the nontax advantages must outweigh the tax advantages to such an extent that the tax advantages are reduced to mere relics.[28] Hence, a tax arrangement does not escape the M.B.T. solely by providing proof of considerable nontax reasons.[29]

Hallmarks That Require a Finding Under the M.B.T.

The Hallmarks that require a finding as to the main benefit are the following:

"In accordance with the Directive, the German implementation distinguishes two types of Hallmarks which must be realized in order to give rise to a D.A.C.6 reporting requirement."

- An arrangement where the relevant taxpayer or a participant in the arrangement undertakes to comply with a condition of confidentiality which may require them not to disclose to other intermediaries or the tax authorities how the tax arrangement could realize a tax advantage.
- An arrangement where the intermediary is entitled to receive a fee for the arrangement and that fee is fixed by reference to the amount of the tax advantage derived from the arrangement or includes an obligation on the intermediary to partially or fully refund the fees where the intended tax advantage derived from the arrangement was not partially or fully achieved.
- An arrangement that has substantially standardized documentation or structure and is available to more than one relevant taxpayer without a need to be substantially customized for implementation.
- An arrangement whereby a participant in the arrangement takes contrived steps which consist in acquiring a loss- making company, discontinuing the main activity of such company, and using its losses in order to reduce the participant's tax liability, including through a transfer of those losses to another jurisdiction or by the acceleration of the use of those losses.
- An arrangement that has the effect of converting income into capital, gifts, or other categories of revenue which are taxed at a lower level or that are exempt from tax.

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27 The German legislator did not further categorize the hallmarks. Therefore, the categories set out in the annex of the D.A.C.6 Directive are not reflected and thus the distinction of various specific hallmarks into specific hallmarks, for which the main benefit test applies, and specific hallmarks, for which it does not apply, is not implemented as categorization type in Germany.

28 Draft Decree, no. 108.

29 *Id.*

- An arrangement which includes circular transactions resulting in the round-tripping of funds, namely through involving interposed entities without other significant commercial function or transactions that offset or cancel each other.
- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the recipient is tax resident in a jurisdiction, that does not impose any corporate tax or imposes corporate tax at the rate of zero or almost zero.
- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the payment benefits from a full exemption from tax in the jurisdiction where the recipient is resident for tax purposes.
- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the payment benefits from a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes.

Other Hallmarks for which the M.B.T. is not Relevant

The Hallmarks that do not require a finding as to the main benefit are the following:

- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the recipient is not tax resident in any tax jurisdiction.
- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the recipient is tax resident in a jurisdiction that is included in a list of third-country jurisdictions which have been assessed by Member States collectively or within the framework of the O.E.C.D. as being noncooperative.
- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where depreciation deductions for the same asset are claimed in more than one jurisdiction.
- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where relief from double taxation in respect of the same item of income or estate is claimed in more than one jurisdiction.
- An arrangement that includes transfers of assets with a material difference in the amount being treated as payable in consideration for the assets in those jurisdictions involved.
- An arrangement which may have the effect of undermining the reporting obligation under the laws implementing the E.U. automatic exchange of financial account information under common reporting standard.
- An arrangement involving a nontransparent legal or beneficial ownership chain with the use of persons, legal arrangements or structures that do not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises and that are incorporated, managed, resident,

controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements or structures and where the beneficial owners of such persons, legal arrangements or structures, as defined in sec. 3 of the German Money Laundering Act, are made unidentifiable (a "nontransparent chain").

- Arrangements concerning transfer pricing arrangements involving the use of unilateral safe harbor rules.
- Arrangements concerning pricing for the transfer of intangibles or rights in intangibles for which, at the time of the transfer between associated enterprises, no reliable comparable elements exist, and at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer ("hard to value intangibles").
- Arrangements concerning transfer pricing arrangements involving an intragroup cross-border transfer of functions, risks assets, or other advantages, if the projected annual earnings before interest and taxes ("E.B.I.T.") of the transferor during the three-year period after the transfer are less than 50% of the projected annual E.B.I.T. of such transferor had the transfer not been made. In this Hallmark it is assumed that the associated enterprises must act in accordance with the principles of proper and conscientious business managers. These regulations also apply to permanent establishments.

Guidelines for the Interpretation of the Hallmarks

The guidelines for the interpretation of all of the Hallmarks in the Draft Decree are not voluminous much uncertainty continues to exist. However, with respect to the Hallmarks in connection with confidentiality clauses, standardized documentation, and anti-hybrid Hallmarks concerning the deduction of business expenses that are paid to a resident of a low tax jurisdiction, several bits of guidance appear useful.

- Regarding a confidentiality clause that requires nondisclosure of the rational of a tax planning arrangement, the Draft Decree suggests an exception that allows disclosure to the tax administration and other intermediaries having comparable reporting obligations with regard to the transaction.[30] It also advises that confidentiality clauses with respect to the preparation of tax declarations, bookkeeping, annual audits, engagement letters for due diligence reports and the due diligence report itself does not fall under this Hallmark.[31]
- With respect to the use of standardized documentation and structure, the Draft Decree provides a list of standardized legal and tax advice that are not proscribed under Hallmark, if occurring in isolation That list includes standard forms *inter alia* with respect to the following tasks:

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[30] Draft Decree, no. 120.

[31] Draft Decree, no. 121.

- ○ Setting up a company
- ○ Granting a loan or license
- ○ Settlement of payment and securities transactions
- ○ Amending continuing obligations solely to meet arm's length conditions

Nonetheless, circumstances that comprise an isolated event in this context are not explained. In addition, the exception applies in general, which means that a certain residual risk remains regarding exceptions. However, it seems that standardized documentation can be used if it is limited to setting-up of a company, issuance of loans or licenses, secondment of employees, payment services, and standardized leasing contracts.[32]

"Nonetheless, circumstances that comprise an isolated event in this context are not explained. In addition, the exception applies in general, which means that a certain residual risk remains regarding exceptions."

- In case of a tax arrangement that involves deductible cross-border payments made between two or more associated enterprises where the recipient is tax resident in a jurisdiction that does not impose any corporate tax or imposes corporate tax at the rate of zero or almost zero percent, the Draft Decree defines "almost zero" as up to 4%,[33] which is much higher than the 1% European standard threshold.[34]

The White List

The German legislator empowered the tax administration to provide a "White List." Tax arrangements or tax aspects on that list do not qualify as tax advantage arrangements if they concern solely German tax. While the idea of having a White List was well appreciated by practitioners, in the end the list is quite short and considered as the absolute minimum. It is not likely to be expanded prior to the publication of the final version of the Decree.

Procedural Aspects

Competent Authority

The competent authority for D.A.C.6 reporting is the Federal Tax Office (*Bundeszentralamt für Steuern*). It is designated to receive reports of intermediaries that are tax resident in Germany. It can also receive reports from intermediaries that are not German tax resident where the intermediary is tax resident outside the E.U. and fulfills one of the following three requirements set out in sec. 138f (7) A.O.:

- The intermediary has a permanent establishment in Germany, through which the services with respect to the tax arrangement are provided.
- The intermediary is registered in the German commercial register or another German public professional register.
- The intermediary is registered with a professional association related to legal, tax, or consultancy services in Germany.

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32 Draft Decree, no. 130.

33 Draft Decree, no. 150.

34 Summary Record prepared by the E.U. Commission Services, E.U. Working Party IV -Direct Taxation of 24 September 2018, p. 5.

Hence, a French corporation with German permanent establishment is not required to report in Germany (but probably in France). A U.S. corporation with German permanent establishment is required to report with the Federal Tax Office in Germany.

A failure to report based on gross negligence or a willful disregard of the rules result in the imposition of a fine of up to €25,000 for each failure to report. While such maximum amount may be rather low compared to other E.U. Member States, the extent of the failures add up.

Legal Professional Privilege

In principle, lawyers, tax advisors or other groups providing services that give rise to a professional privilege recognized by German law opt out of the full reporting under certain requirements if released by the taxpayer.

This does not lead to a full reporting obligation of the taxpayer, but to a reporting obligation that is split. The lawyer, tax advisor or other intermediary has an obligation to file a partial report of non-individualized information. The report may include the following:

- A summary of the content of the reportable arrangement
- The details on all applicable Hallmarks
- The date on which the first step in implementing the reportable arrangement
- The details of the relevant national provisions
- The value of the reportable arrangement.

The taxpayer is, then, obliged to report the individualized information in its partial reporting. In the end, a full report is filed, comprised of two partial reports.

The intermediary must inform the taxpayer about the taxpayer-related information it reported to the Federal Tax Office. The taxpayer must include in its partial report the registration number and the disclosure number of the intermediary's partial report. The 30-day reporting period for the taxpayer begins to run when it receives the required information from the intermediary.

Reporting in Another E.U. Member State

Several intermediaries that work on the same tax arrangement transaction are each responsible to report independently on that arrangement. However, once the Federal Tax Office receives a report on a particular tax arrangement or has been advised properly that a report was already filed with the competent authority of another E.U. Member State in accordance with the local D.A.C.6 requirements of that Member State, the obligation of a German intermediary is deemed to be satisfied.

For the foregoing rule to apply, the German intermediary must, upon request, submit proof that the tax arrangement was reported. Initially, degree of proof that was required to be submitted was not clear. However, the Draft Decree provides a practical solution – it is sufficient to provide the registration I.D. number (called the "arrangement I.D. number or reference number) and the disclosure I.D. that relates to the initial reporting by the other intermediary.[35] The German Tax Administration requires that the intermediary who wants to benefit from the foregoing process must have been reported by the initial intermediary in its reporting.[36]

Reporting Another Intermediary

If an intermediary knows that at least one other intermediary is involved, it must include general personal information about that other intermediary the D.A.C.6 reporting filed with the Federal Tax Office. Once an intermediary files a D.A.C.6 report with the Federal Tax Office, it receives a registration number, which must be provided to all other intermediaries. Once the registration number is obtained, other intermediaries do not receive a further registration number for that tax arrangement from the Federal Tax Office.

CONCLUSION

In Germany, the reporting requirements are continuously increasing. This triggers high costs for all participants. It is doubtful whether the aim of all such new requirements will be reached, including, the avoidance of truly abusive tax structures. If the tax authorities are inundated with excessive data, abusive structures can be missed. In addition, German tax authorities do not have enough personnel to monitor cross-border arrangements and may require initial screening through the use of artificial intelligence. Perhaps it would have been a better alternative for the German tax authorities to expand its team of tax auditors so that audits could be concluded on a more rapid basis. In Germany, the tax examination teams often focus on tax periods that ended more than five years in the past.

35 Draft Decree, no. 98.

36 *Id.*