Key German Transfer Pricing Trends

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1. Introduction
In nearly every tax audit in Germany, of taxpayers with cross-border transactions, transfer pricing issues are covered and transfer prices are scrutinized. German tax authorities still spend a lot of effort in training their tax auditors in the transfer pricing area.

Further, the 2008 German tax reform seeks a comprehensive overhaul of the German tax system. The objectives of this tax reform are to improve Germany’s position in global competition and to avoid profit shifts to other tax jurisdictions for tax planning purposes.

The new bill includes a reduction of the combined corporate and trade tax rate for corporations by approximately nine percentage points. Additionally, the bill introduces several counter measures to increase the tax basis. The most notable counter measures are the General Interest Expense Disallowance Rule which is governed by Section 4h of the Income Tax Act and changes regarding transfer pricing in Section 1 of the Foreign Tax Act. The following summary highlights in particular the new rules on transfer pricing.

2. Legislative and administrative developments
2.1 German Business Tax Reform 2008, here: new transfer pricing rules
The law includes new transfer pricing legislation especially relating to the transfer of business functions to other tax jurisdictions. The German government’s aim is to ensure that strict rules exist regarding transfers of business functions and business restructurings.

To provide guidance on compliance and in an effort to make the new regulations more administrable, the German Finance Ministry will additionally release i) Executive Order Laws binding for taxpayers, tax authorities and tax courts, and ii) Administration Principles binding tax authorities. On June 4, 2007 the Federal Ministry of Finance (BMF) published a first draft of the Executive Order Law on the transfer of business functions. A further Executive Law dealing with the arm’s length principle is to be expected for spring 2008.

The following highlights of the legislation (amendment of Section 1 Foreign Tax Act, which is going to be effective for the tax assessment period 2008) will be emphasized below and include:

- a general definition of the arm’s length principle, as well as significant details on the determination of transfer prices and the use of ranges for profit level indicators in the absence of internal or external comparables, e.g. the use of the interquartile range of identified values;
- business restructurings (relocation of functions); and
- transfer pricing adjustments (a kind of commensurate with income approach).

Arm’s length test
In the new Section 1 subs. 1 Foreign Tax Act it is stated that for the application of the arm’s length principle it is assumed that unrelated parties are aware of all essential circumstances of a transaction and act on principles of a prudent and diligent business manager at the time of the relevant transaction. This sound and prudent business manager test is however, shall be narrowed. When the price, used by the taxpayer is in an appropriate transactional transfer pricing method. Additionally, in this transactional transfer pricing methods (the comparable uncontrolled price method, the resale price method or the cost-plus method). If only limited comparable data (eg gross margins, mark-up on costs) is available, this data shall be used for the determination of the transfer prices using an appropriate transactional transfer pricing method. Additionally, in this latter case, if more than one limited comparable data were identified, a range has to be determined. This range of limited comparable data, however, shall be narrowed. When the price, used by the taxpayer is in cases of full comparability of data outside the range or in cases of limited comparable data outside the narrowed range, the median shall be applicable.

When performing a hypothetical arm’s length test a so-called range of potential agreement will be determined. This range of potential agreement will be the result of the performance of analyses of functions and risks and internal financial planning by forecasting of the profit expectations in the relevant transaction (profit potential). The range will be comered by the maximum price a fully informed diligent buyer would pay and the minimum price a fully informed diligent seller would accept. It is important to note that the determination of the price is not only conducted from the view of the seller/provider or the buyer/recipient but both. This means that in practice (eg transfer of intangible assets) two valuations have to be conducted. It is implied that all relevant circumstances of a transaction are well known even among unrelated parties, so complete transparency and information is given. Based on that it is expected that a taxpayer does not only make use of its own information but also knows about and exploits the information of the other contracting party in evaluating the value of the business function, which is subject to the transfer.

The price which complies with the arm’s length principle with the utmost probability shall be used as transfer price for the transaction. If a taxpayer does not substantiate a certain price within the range of potential agreement the mid-point between the two values is deemed to be the price the two prudent business managers would have agreed on. The presumption of the mid-point is deemed to be the price the two prudent business managers would have agreed on. The presumption of the mid-point is deemed to simulate the outcome of fictitious negotiations between unrelated parties.

Business restructuring (relocation of functions)
The government not only intends to tax situations where intangibles are relocated to an associated enterprise or permanent establishment in another tax jurisdiction, but under the new law, it is sufficient if mere advantages or profit expectations that cannot be regarded as intangible assets will be transferred abroad. According to the new Section 1 subs. 3 sentence 9 Foreign Tax Act in connection with the first initial draft Executive Order Law a shift of functions is assumed, if a function together with its related chances and risks as well as advantages (a so-called transfer package) is transferred or surrendered between affiliated companies. Additionally, the first initial draft Executive Order Law shall apply to so-called functions that are duplicated, ie when "without restriction of the previous business activity, a related entity assumes a function performed by the former entity using its assets and advantages". In this case, the principles for taxation of the shift of functions are to be applied also for the duplication of functions according to the arm’s length principle. Thus, a transfer of functions is assumed for tax purposes even if the functional profile of the German transferor does not change at all. This draft provision causes very controversial discussions and one can be anxious about it whether this rule will find its way into the final Executive Order Law.

Basically a payment for the transfer of a function has to be calculated for the transfer of a function as a whole. This means a valuation of the (whole) transfer package has to be made. The transfer package could consist of assets and other advantages. A payment would then be calculated based on the differences in projected profits of the German affiliate and the affiliate receiving the function, ie the discounted/capitalized earnings value of the transferred profit potential. The profit expectation related to the transfer package is to be determined both from the view of the transferee and the transferor. As mentioned above, this means that in practice two valuations have to be conducted. Compensation would have to be paid not only in cases where intangibles were transferred, but also if advantages in the form of profit potential are transferred, as mentioned above. In certain exceptional cases a valuation of each single asset is allowed, eg if no valuable, essential intangible assets is transferred.

The law also introduces the interquartile range concept into legislation and requires an income adjustment by the tax authorities to the median (as the arm’s length value) if the price the taxpayer has agreed on is outside the range of arm’s length prices. Previous decisions of the Federal Tax Court only allowed adjustments to the end point of the range that was most beneficial to the taxpayer.

The new legislation also introduces the concept of the hypothetical comparison for those cases where no internal or external comparable data is available. In case of no comparables the so-called “agreement range” of
the transfer package price is to be determined by the hypothetical arm’s length principle. A hypothetical comparison means considering the range between the maximum price a fully informed diligent buyer would pay and the minimum price a seller would accept. Generally speaking, the arm’s length price would then be the probable value within that range, which is generally deemed to be the mid-point between the two. However, the latter can be disproved by the taxpayer. The overall effect of this approach is that, for example, synergy effects and location savings may be “split” between the parties involved in the transaction.

The German transfer pricing legislation imposes a “commensurate with income” standard that will apply to the relocation of material/essential intangible assets and functions if the actual profit development differs substantially from the forecasted profit development that was the basis for the estimation. It will require multinational corporations to agree on adjustment mechanisms for a payment made to German affiliates for the transfer of functions unless the taxpayer provides strong arguments that such adjustment mechanisms are not arm’s length. This hypothetical pricing adjustment mechanism is introduced with the rebuttable presumption that at the time when the transaction was concluded uncertainties concerning the price agreements existed and unrelated parties would have agreed to an appropriate pricing adjustment mechanism. This will allow tax authorities to perform a price adjustment (in case of a transfer of essential assets and opportunities) in case of a significant deviation of actual business developments and results from the forecast (assumptions and budgets) used to calculate the transfer remuneration, for a period of 10 years after the transfer. A significant deviation is deemed to exist if the actual value of a transaction is outside the agreement range. Such an adjustment can only be made once. According to the proposed law, an appropriate one-time adjustment amount that amends the original transfer price has to be calculated in the year subsequent to the year in which the deviation took place. This also means that only one and the first substantial budget deviation can be “corrected”. Further budget deviations cannot lead to further recalculations of the remuneration.

The application of the pricing adjustment provision can be avoided if the taxpayers agreed about an arm’s length adjustment provision on their own.

Further amendments

Under current transfer pricing documentation requirements, documentation for extraordinary business transactions must be prepared contemporaneously. The deadline to submit such documentation was now shortened to 30 days after a tax auditor’s request from the current 60 days because of the obligation for contemporaneous documentation such documentation should be available anyway. Additionally, the law allows the tax authorities to estimate the taxpayer’s income if information and documents cannot be received from related parties. Furthermore, there are some changes of the Executive Order Law with Regulations on the Type, Content and Scope of Documentation as understood in Section 90 (3) of the General Tax Act (Abgabenordnung), November 13, 2003, which relate to the definition of extraordinary transactions, the exemplary mentioning of deemed extraordinary transactions such as restructurings and cost contribution arrangements as well as the necessity to have a detailed documentation for research & development activities which could be connected to a change in functions/function transfers.

Further completely new debt-financing rules (so-called “interest barrier” rules) and rules to restrict the use of losses are introduced.

2.2. Administrative developments – expected further regulations

The German tax authorities started to continue their work on Administration Principles regarding the transfers of business function between related companies some years ago. This work has been postponed now because of the legislative change that was enacted with the Legislation for 2008 (see above). Now, as mentioned above, a draft public circular on the transfer of business functions was expected in autumn 2007, but no new draft circulars were published so far.

In addition, the Federal Ministry of Finance has started to work on the amendment of the Administration Principles relating to the Allocation of Income in the Case of Permanent Establishments of Internationally Operating Enterprises (Administration Principles – Permanent Establishment), dated December 24, 1999. This circular requires some adaptation not only because of the recent changes of the German tax law, in particular as far as the transfer of assets between permanent establishments abroad is concerned.

3. New Published Circulars

3.1. Updated Note of the Federal Ministry of Finance on Mutual Agreement Procedures and Procedures under the EU-Arbitration Convention

On July 13, 2006, the German Federal Ministry of Finance issued an updated Note on Mutual Agreement Procedures that allows the taxpayer to avoid double taxation and to resort to the competent authorities if, pursuant to a transfer pricing adjustment made by the German tax authorities, the other country’s tax authority is willing to offset such adjustment by making a correlative adjustment. In the new note the administrative competence for mutual agreement procedures has been centralized at a federal level in the Federal Central Tax Office (BZSt), which is the competent authority. The note updates the previous guidelines to regulate the procedural framework of the mutual agreement procedure. In general, the competent authorities are willing to negotiate and use their best efforts to eliminate the double taxation, but are not obliged to achieve a result. This is different in mutual agreement procedures under the European Arbitration Convention amongst the member states of the European Union are obliged to resolve disputes where double taxation of income due to the adjustments of profits of associated enterprises and the adjustment of profits attributed to permanent establishments are concerned. The new note describes the process and procedural rules on the arbitration procedure. It also includes provisions regarding the publication of the opinion of the so-called advisory commission and the response of the competent authorities, taking into consideration the confidentiality and discretion needs in German tax matters.

3.2. Note of the Federal Finance Ministry on Advance Pricing Agreements (APA)

The German Ministry of Finance issued a Note on Bilateral and Multilateral Advance Mutual Agreement Procedures based on the Mutual Agreement Procedure Provisions of Germany’s Tax Treaties (so-called “Advance Pricing Agreements” – APAs) on October 5, 2006 which defines the APA procedures and provides guidance with regard to the negotiation of APAs. In terms of content and application the German principles in general correspond with common international and OECD standards. The administrative competence for APAs is centralized in the Federal Central Tax Office, the BZSt. The BZSt has published a list of information and documents that have to be included and annexes that should be attached to the written application. The taxpayer must also pay a fee. The APA process typically takes from 1.5 years to several years from application to conclusion. Depending on the case it is expected that the APA term is usually between three to five years. However, the taxpayer may apply for a longer term. The earliest start date of the APA is the beginning of the business year in which the tax authority receives the application. Under certain conditions they may also refer to previous years (a rollback). An agreement reached between the two competent authorities will be made conditional in two regards, the taxpayer must consent to the intergovernmental agreement and must waive its right to appeal against tax assessments to the extent they are in line with the contents of the APA. Overall, the note provides valuable guidance to taxpayers seeking certainty about their intercompany pricing policy. If the tax administration makes available sufficient personnel resources to accommodate the flow of applications APAs could well become a popular mean of managing transfer pricing risks.

4. Closing remarks and outlook

German tax authorities are working heavily on completing their specific regulatory framework on transfer pricing which shows again the outstanding importance of transfer pricing in Germany. Besides its tax planning opportunities transfer pricing, therefore, is in particular a risk management issue that requires taxpayers to focus particularly on the compliance area, i.e. to prepare and maintain comprehensive transfer pricing documentation, as well as to utilize eg APAs as an appropriate tool of (in advance) dispute resolution. With the recent legislative developments together with tax authorities becoming more and more sophisticated in approaching transfer pricing issues, the “good old times” of bargaining about a constructive dividend in a tax audit are irrevocably over.

1. Section 1 subs. 4 sentence 1 FlVerlagV-E
2. Section 1 subs. 3 sentence 4 Foreign Tax Act
3. Section 1 subs. 3 sentence 11 Foreign Tax Act
4. Section 90 subs. 3 German Tax Act (Abgabenordnung)
5. There are few exceptions under which Germany is obliged to put a tax dispute to arbitration. This clause is included in the new tax treaty Germany and Austria. A ratification for an equivalent amendment to the tax treaty between Germany and the United States is expected soon.