

German Transfer Pricing Modifications: Challenges for Multinational Taxpayers

13th October 2021

Agenda



Background

Change #1: German Foreign Tax Law (Außensteuergesetz - AStG)

Change #2: General Tax Code (Abgabenordnung - AO)

Change #3: New administrative Guidelines (2020)

Change #4: New administrative Guidelines – Transfer Pricing (2021)

Background

- Update of the German transfer pricing environment according to OECD / BEPS Action 8 -10 and OECD Transfer Pricing Guidelines (TPG) 2017
- Affected laws
 - Law #1: Abzugssteuerentlastungsmodernisierungsgesetz (AbzStEntModG): adopted on 28.5.2021.
 - Law #2: ATAD Implementing Act, adopted 25.6.2021
- Outdated set of Administrative Guidelines on Transfer Pricing requires an update

Change #1: Foreign Tax Law

General changes

Restructuring of § 1 AStG

- § 1 Abs. 1 AStG: editorial changes
- § 1 Abs. 2 AStG: incorporation of ATAD Implementation Act
- New § 1 Abs. 3a and 3b AStG: Determination arm's length price
- New paragraph 3c: DEMPE Analyse and intangible assets

New § 1a AStG

- Introduction of a price adjustment clause

Definition arm's length price

- Actual conditions decisive
 - Contractual arrangement as a starting point: reference to chapter 1.42 OECD TPG 2017
 - Functions/risks/assets
 - Characteristics of assets and services
 - Economic circumstances
 - Business strategies.
- Reference to chapter 1.36 of the OECD TPG 2017.
- Alignment of I/C contract with factual conduct.

Functional and risk analysis

- Legal definition of the F/R analysis in German law
 - Functions performed / risks taken / assets used
 - Characteristics of assets/services
 - Economic circumstances in the industry/market
 - Legal framework
 - Business strategies
- Reference to OECD TPG 2017.
- Actual conduct relevant.

Comparability analysis

- Legal definition of a comparability analysis in German law
- Actual circumstances of the transactions of independent third parties are to be determined
- Contractual conditions
 - Functions exercised/risks carried/assets used
 - Characteristics of assets/services
 - Consider the economic conditions of the market / locational advantages
 - legal framework,
 - Business strategies
 - Reference to chapter 3.1 of OECD TPG 2017
- “Reflection” of the taxpayer expected in the case, that there are no comparable transactions
- Position e.g. China on locational advantages: to be examined / if necessary to be accepted by German tax authorities

Time of agreement relevant

- Clear deadline principle: "To be based on the circumstances at the time of the agreement of the transaction".
- Consequences on Price Setting or Outcome Testing?
- Controversial: is the outcome testing approach no longer accepted? Not clearly excluded!
- *Example:*
 - The date of the agreement is FY 2020 with a benchmark for 2016-2018 (price setting),
 - The date of the review/tax determination of profit is the FY 2021 with a benchmark for 2016-2018/alternatively 2017-2019 (outcome testing),
 - Is this covered by the regulation?

Best method rule

- Arm's length price according to the most suitable transfer price method in the individual case.
- No method hierarchy.
- However, the justification for the law in turn still provides for a preference for the standard methods over the profit methods and in particular for the price comparison method/CUP.
- Complete method discussion or demarcation of the methods required?
- Point 46 of the VG 2020: Right of the tax administration from its point of view to select more suitable method if its results are "more likely" in accordance with the obligation of the taxpayer to provide information and documents.
- Where is the boundary between the tax authorities and taxpayers rights?
- Some "uncertainties in comparability" will always exist.

Bandwidth determination

- Does not set to "the" individual value, but to a range of comparables.
- Narrowing of the range required if differences in comparability remain.
- new: adjusting to interquartile range, i.e. the lower and upper quartiles are excluded from the determination of the range.
- Correction to median if the value used is out of the range.
- New: Opening clause allows a value outside the range, if the taxpayer can make credible that this value is in conformity with a third-party comparison.

Intangible assets and DEMPE concept

- New rule in German law.
- Chapter VI OECD TPG 2017 finds legal basis in national law.
- Transfer or transfer of use of an intangible **value** (not necessarily economic asset!) on the basis of para. 4 and in connection of a financial effect is to be remunerated.
- Definition of intangible values.
- Determination of ownership or ownership, synonymous with "legal owner".
- Adoption of DEMPE factors from international OECD standards.
- Functions/risks/use of assets related to DEMPE opens a right for remuneration against the (legal) owner.
- A mere financing function is to be remunerated in accordance with Chapter X OECD TPG and should not provide access to (co-)ownership on its own.
- Contractual risk assumption also presupposes the actual control of the risk.
- The remuneration of DEMPE functions should not be linked or prescribed to any specific TP methodology.

Change #2: General Tax Code (AO)

Performance of Advance Pricing Agreements (APAs)

- New regulation in § 89a AO refers to the fact sheet on APAs from 2006.
- The instrument of the APA is expressly intended by the the German tax administration and improvement of legal certainty desired.
- DTT with Germany including a MAP clause must exist .
- Corresponds to Art. 25 OECD MT 2017.
- Application only for a situation that has not yet been realised for a certain period of validity.
- APA period usually 5 years.
- Application fees:
 - 30,000 euros fee for initial application (previously 20,000 euros).
 - 15,000 euros fee for follow-up application/extension (previously 10,000 euros).
 - SME scheme: EUR 10,000 or EUR 7,500.

Change #3: Administrative Guidelines 2020

Existing set of TP Guidelines until 2021

Previous Set of TP Guidelines until 2021, e.g.

- Administrative Guidelines 1983
- Administrative Principles on Procedures 2005
- Administrative Instruction on the use of use of names in the Group 2017
- Administrative principles on CCAs 2018
- Administrative principles on MAPs 2018
- Administrative principles on ECJ case Hornbach 2018

New Set of TP Guidelines as of 2021

- Administrative Guidelines 2020 (VG 2020)
- Administrative Guidelines Transfer Pricing 2021 (VG TP 2021)

Background

- The VG 2020 is part of the update 2020/2021.
- The VG 2020 are applicable to all open cases with immediate effect.
- However, the MOF tends to go one step further with the VG 2020 and tightens the German documentation requirements on this occasion.

Key elements

- Extended obligations to cooperate and submit documents;
- Domestic retention periods extended to foreign countries;
- Introduction of a Best Method Rule;
- Important topics such as digital business models or value chain analyses (VCA) are not addressed;
- Criminal tax aspects will become even more relevant in the future;
- Applications for recognition of other languages are becoming more significant;
- Right of the tax authorities to select an alternative TP method;
- Request for TP documentation also possible outside of a tax audit in the future; and
- Preliminary discussions and reconciliations with the tax authorities offered.

Best method rule

- A **best method rule** obliges the taxpayer to explain and justify why it considers the chosen method to be the most suitable method.
- The letter grants the **tax authorities** the right to select the "**correct transfer pricing method**" themselves in the form of the method they consider to be the most appropriate. For this purpose, it is supposed to be sufficient that the results of the alternative method applied are "**more probable**". However, the letter leaves it completely open how this probability is to be determined. The taxpayer has to provide the necessary information, used against him in case of doubt (!).

Power of estimation extended

- Extended power of estimation for the German tax authorities
- A so-called “spoiler of evidence” must expect that an appraisal will be carried out.
- The unspecified term "**highest possible probability**" is intended to ensure that the tax authorities determine and apply the "**correct**" transfer price in the case of an estimate. Database studies should be permissible for estimation purposes.
- Usable records should not be able to prevent the tax authorities from nevertheless demanding further information or carrying out checks. Thus, usable records do not exclude estimates. Fishing expeditions to be expected.

Change #4: Administrative Guidelines Transfer Pricing 2021

Close integration of the OECD TPG 2017

- OECD TPG 2017 largely adopted in German tax law
- Reference to an international TP standard: The aim is a harmonization of TP standards to avoid or reduce tax disputes.
- OECD TPG 2017 are a compromise between the OECD member countries and are a comment only: what is the legal character?
- To what extent do the OECD TPG 2017 have a legally binding character for the taxpayer?
- Temporal applicability: numerous current tax audit cases in which it is disputed from when e.g. the DEMPE concept is applicable. Before 2017? Since 2017? As of 2021?
- Applicable 100% for non DTT cases:
 - Example Brazil: Germany has no DTT with Brazil and Brazil is not an OECD member country
 - What applies to the taxpayer and on what basis would the tax authorities agree?

Principles of profit corrections

- Profit adjustments according to § 1 Foreign Tax Act are complementary to profit adjustments on the basis of hidden profit contributions according German corporate tax law.
- Clarification of the legal basis on which profit adjustments are to be made.

Extension of related party definition

- Networks: if one party has an interest in another party making a profit, this falls under the definition of related parties
- Examples can be sports associations, e.g. FIFA or UEFA

Arm's length principle, TP methods and comparability analysis

- Extensive reference to the OECD TPG 2017
- Arm's length principle according to the OECD TPG 2017 complemented by the principle of a prudent business manager behaviour
- Not an independent transaction partner but the **profit-maximizing** transaction partner is required: conflict with the arm's length principle in general?
- Full adoption of TP methods according to the OECD TPG 2017
- Complemented by the hypothetical arm's length comparison concept
- Full adoption of the principles on a comparability analysis according to the OECD TPG 2017
- Concept of middle and hybrid entities deleted

Loss situations

- Clarification that in case of doubt a loss is to be absorbed by the entrepreneur of a MNE group
- Routine companies should achieve a positive result over a period of 5 years, otherwise no recognition
- Possibility of correction of results provided by sales companies in the case of the same prices as third parties, but deviating terms and conditions
- Timing of pricing is decisive

Dispute resolution & TP documentation

- Dispute resolution: reference made to fact sheets on
 - Dispute Resolution (2018) and
 - Coordinated tax audits (2018)
- TP Documentation: reference made to Administrative principles 2020, i.e. OECD TPG 2017

DEMPE concept & I/C services

- DEMPE concept:
 - reference made to the OECD TPG 2017
 - Control over risk concept implemented
 - This is questionable whether it will actually become an international standard and the timing
 - Court case Belgium: for FY 2009 not OECD TPG 2017 applicable but the OECD TPG 1995
- I/C services: reference made to chapter VII of the OECD TPG 2017
 - Separate billing in addition to goods deliveries and services if a third party would pay for it separately
 - Actual provision of services required
 - Cost plus on full cost basis required
- Low Value I/C Services: reference made to the OECD concept on LVICS and acceptance of a mark-up of 5%

Financial transactions

- Financial transactions: full reference made to chapter X the OECD TPG 2017
 - I/C loans: equity or debt capital? Trend in Germany for qualification of I/C loans as equity in inbound cases
 - Treasury function: groupo service function to be remunerated on a cost plus
 - Cash pooling: cash pool leader to be remunerated on a cost plus
- No legal anchoring took place in the Foreign Tax Act (as initially intended): this area remains open

Take away

Take away

- Although the extensive alignment with the OECD TPG 2017 increases legal certainty, many points remain unclear or are not sufficiently defined.
- Taxpayers should review their transfer pricing documentation for all open years with regard to the new requirements under the German Guidelines 2020/2021, and
- if necessary, rework and supplement it in order not to run the risk of not meeting the new requirements and/or even ending up in an estimation situation.
- The retroactive applicability of the OECD TPG 2017 to old years has not been clarified and remains a point of contention.

Thank you very much!

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