

2020 and 2021 Transfer Pricing Trends in Germany

Extensions in law and guidelines on mandatory
documentation

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Agenda

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 - § 1 Abs. 6 AStG: authorisation of the ministry of finance for regulation of the arm's length principle by an ordinance
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(1) Introduction and Background

- OECD / BEPS Action 8 -10 and OECD Transfer Pricing Guidelines 2017
- Affected laws
 - Abzugssteuerentlastungsmodernisierungsgesetz (AbzStEntModG): adopted on 28.5.2021.
 - ATAD Implementing Act, adopted 25.6.2021)
- Administrative principles 2020

(2) Foreign Tax Law (AStG)

General changes

1. Restructuring of § 1 AStG

- § 1 Abs. 1 AStG: redaktionelle Änderungen
- § 1 Abs. 2 AStG: ATAD Umsetzungsgesetz
- § 1 Abs. 3 AStG:
 - Separation in two in new paragraphs 3a and 3b
 - Determination arm's length price
- New paragraph 3c: DEMPE Analyse und IWG

2. New § 1a AStG

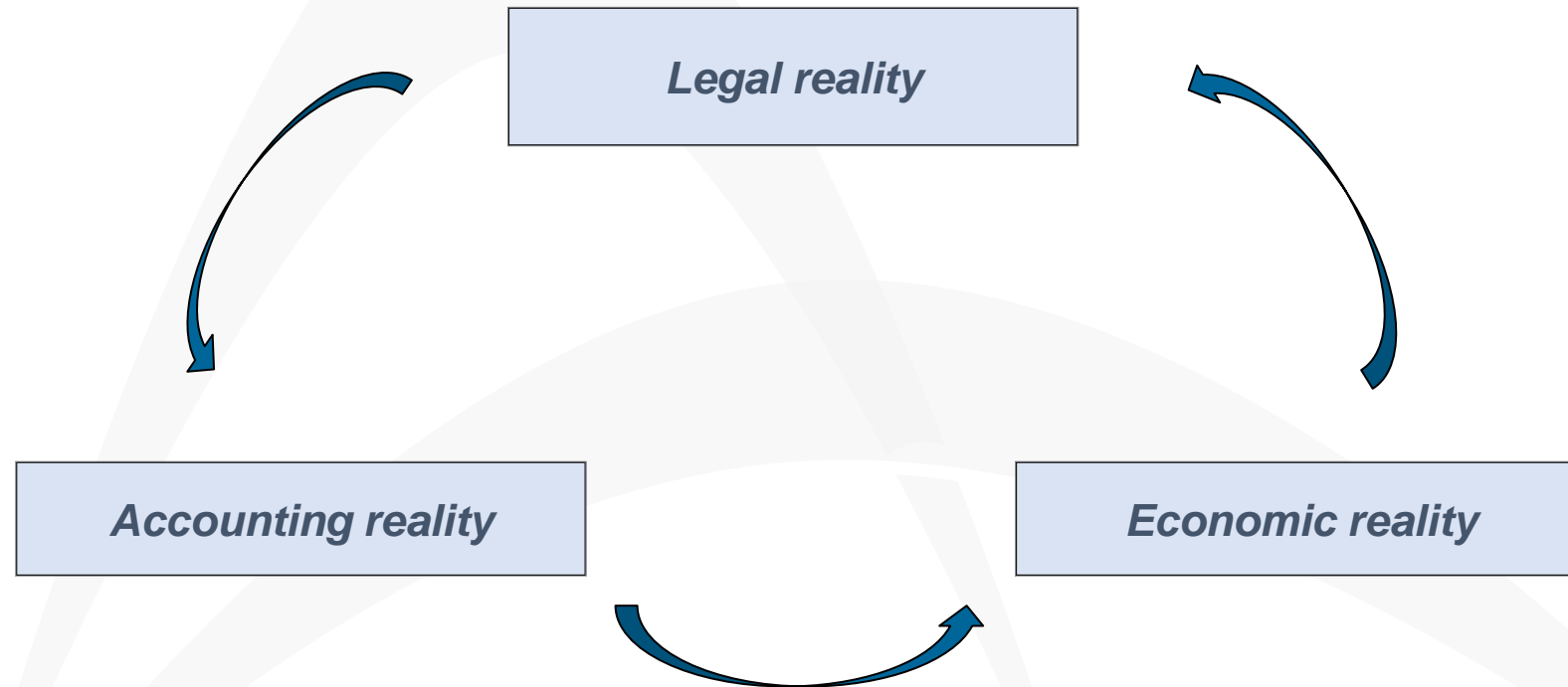
- Price adjustment clause

3. Application rule in § 21 Abs. 25 AStG

§ 1 Absdefinition1 AStG: definition arm's length price

- Actual conditions decisive
 - Contractual arrangement as a starting point
 - Functions/risks/assets
 - Characteristics of assets and services
 - Economic circumstances
 - Business strategies.
- Link to chapter 1.36 of the OECD TPG 2017.
- Alignment of I/C contract with actual behavior.
- Tz 1.42 OECD TPG 2017: Contractual arrangement = starting point for further analysis.
- Magic vs. Bermuda Triangle.

Magic vs. Bermuda triangle



Example: Head of Central Purchasing is physically located in France; per I/C contract & according Accounting however, the function is located at the parent company in Germany.
Legal & Accounting realities \neq Economic reality

§ 1 Abs. 3 Satz 2 u. 3 AStG: functional and risk analysis

- Legal definition of the der F/R analysis in German law
 - Functions performed
 - Risks taken
 - Assets used
 - Eigenschaften der Vermögenswerte/Dienstleistungen
 - Economic circumstances in the industry/market
 - Legal framework,
 - Business strategies
- Link to OECD TPG 2017.
- Tatsächliche Ausübung der Funktionen relevant.
- Tz 1.51: Bewertung der funktionalen Beiträge auf deren wirtschaftlicher Bedeutung.

§ 1 Abs. 3 Satz 3 AStG: comparability analysis

- Legal definition of comparability analysis in German law
- Reference back to sentence 1: Actual circumstances of the transactions of independent third parties are to be determined and also 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 Tz. 3.1 of OECD TPG 2017
- “Reflection“ 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

§ 1 Abs. 3 Satz 4 AStG: time of agreement relevant

- Price Setting or Outcome Testing?
- Clear deadline principle: "To be based on the circumstances at the time of the agreement of the transaction".
- Controversial: is the outcome testing approach no longer accepted? Not clearly excluded!
- But the reason: conditions at the time of the agreement and objectively foreseeable future developments.
- 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?

§ 1 Abs. 3 Satz 5 AStG: 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 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.

§ 1 Abs. 3 Satz 6 AStG: Adjustments

- Differences between the conditions between one's own business transaction and the transactions used for comparison must be eliminated by appropriate adjustments.

§ 1 Abs. 3 Satz 7 AStG: Hypothetical arm's length comparison

- If no comparative values can be determined, a hypothetical external comparison must be carried out on the basis of "economically recognized valuation methods".
- No special method is prescribed.
- In the justification of the law, the earned value and the DCF method are particularly emphasized.
- The new provision corresponds to the previous sentence 5.

§ 1 Abs. 3a AStG: Bandwidth determination (1)

- Does not set to "the" individual value, but to bandwidths.
- Narrowing of the bandwidth required if differences in comparability remain.
- new: Adjusting to interquartile bandwidth, i.e. the lower and upper quartiles are excluded from the determination of the bandwidth.
- Correction to median if the value used is out of the bandwidth.
- 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.
- Conflict with ATAD Implementation Act:
 - credible provision according to which the taxpayer can make credible a value other than the median within the range;
 - The AbzStEntModG corrects to the median, but the ATAD Implementation Act says that any value within the bandwidth is basically equally likely, so that the taxpayer can claim the lowest value for itself;
 - According to the ATAD Implementation Act, the taxpayer should therefore prove that another value within the bandwidth is more suitable than the median, although all are equally well suited;
 - ECJ decisions on Hornbach/SGL : Correction to the most favorable value of the bandwidth and not to the median.

§ 1 Abs. 3a AStG: Bandwidth determination (2)

- Bandwidth determination in hypothetical third-party comparison:
 - Formation of an area of agreement
 - minimum price of the payer, and
 - Maximum price of the beneficiary.
 - The average value of the area of agreement shall be taken as a basis.
 - Alternatively, make it credible that another value within the scope of agreement corresponds to the arm's length principle.
 - Average value \neq Median
 - The *average value* is the arithmetic mean of a set of numbers. The mean is used for normal number distributions that have a low number of outliers.
 - The *median* is a numeric value that divides the upper half of a set of numbers from the lower half. It is used to determine the central tendency of skew number distributions.
 - These terms are often confused out of ignorance during tax audits.

§ 1 Abs. 3b AStG: Transfer of functions

- Wording of the new regulation slightly changed.
- No longer necessary to transfer economic goods as required in the FVerIV ordinance.
- Other benefits are sufficient.
- Opening clause, provided that no IWG or other advantages were the subject of a transfer of a function.
- No transfer of functions: Routine function based on a cost-plus to the benefit of the transferring company
- Open questions:
 - Only exception rule? What happens to the others? e.g. duplication of function?
 - Change of the FVerIV ordinance planned?
 - Change of the administrative guidelines on transfer of functions planned?

§ 1 Abs. 3c AStG: intangible assets and DEMPE concept

- New rule.
- 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 iVm 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.
- Problem Co-Ownership
- Functions/risks/use of assets related to DEMPE opens a right for remuneration against the (legal) owner.
- A mere financing 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.

§ 1 Abs. 6 AStG: Authorisation to regulate the arm's length principle by an ordinance

- Authorisation for an ordinance to clarify the details of the arm's length principle
- Does this mean: the ordinance on transfer of a function will be re-regulated and the previous ordinance on transfer of a function will be revised, transferred or reformulated?
- New administrative guidelines on the transfer of a function to be expected?

§ 1a AStG: price adjustment clause

- New rule
- Income correction standard: if the subsequent profit development for transactions including intangible assets or advantages differs significantly from the planned one, it is rebuttable assumed that uncertainties have existed on the transfer pricing agreement and that third parties would therefore have agreed on a price adjustment regulation.
- Without a price adjustment clause, the standard applies for 7 years and triggers a tax correction in accordance in the 8th year in the event of significant deviations.
- Materiality limit: > 20% deviation.
- No adjustment required, if the taxpayer makes it credible that the development was not predictable, or
 - he has taken into account the uncertainties in the pricing, or
 - License agreement exists that is based on revenue or profit.

Application



As of 1.1.2022



(3) General Tax Code (A0)

Changes General Tax Code (AO)

- § 89a AO: performance of Advance Pricing Agreements
- Art. 97 § 34 AO: Anwendungszeitpunkt

§ 89a AO: Performance of Advance Pricing Agreements (APAs)

- New regulation.
- Previously based on a fact sheet from 5.10.2006.
- Clarification that the instrument of the APA is expressly intended by the the German tax administration.
- To improve legal certainty.

§ 89a AO: functionality

- A DTT with Germany must exist.
- There must be a mutual agreement clause in the DTT.
- Corresponds to previous practice on the basis of Art. 25 OECD MT 2017.
- Application only for a situation that has not yet been realised for a certain period of validity.
- Only for new business transactions or also possible for (already ongoing) permanent transaction or situations resulting from a tax audit?
- Required at the request of an agreement.
- APA period of validity usually 5 years.

§ 89a AO: conditions

- There must be a risk of double taxation.
- Probability must exist that the double taxation can be avoided by the APA, and
- a consistent interpretation of the agreement with the authority in the other state can be achieved.
- The APA application fee must be fixed and paid indisputably.

§ 89a AO: The APA application

- The application shall contain at least and must be accompanied by appropriate documents:
 1. the precise name of the applicant and of all other interested parties;
 2. the name of the local tax authority and the relevant tax number;
 3. the identification number according to § 139b AO or the economic identification number according to § 139c AO; if the economic identification number has not yet been assigned, the tax number,
 4. the countries involved;
 5. a comprehensive and self-contained presentation of the facts, including the desired period of validity of the prior understanding agreement,
 6. the explanation of why there is a risk of double taxation; and
 7. the declaration as to whether binding information pursuant to § 89 AO, a binding commitment pursuant to § 204 AO, an invocation information pursuant to § 42e of the Income Tax Act or comparable information or commitment has been requested or given in the other Contracting State concerned.
- The application must be made in writing or electronically.

§ 89a AO: The 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).
- The fee shall be fixed before the procedure is initiated.
- SME scheme: EUR 10,000 or EUR 7,500.
- Withdrawal or rejection of an APA application: Fee will not be refunded.

§ 89a AO: Zustandekommen eines APA

- The authority signs the APA pursuant to § 89a sec. 3 p. 1 AO with the other state only if the APA is subject to the condition that:
 - the applicant agrees to the content of the APA, and
 - it waives the lodging of appeals against tax assessments that implement the results of the APA.
- Once signed, the competent authority shall inform the applicant of the content of the APA and set a time limit for him to fulfil the above conditions.

§ 89a AO: Failure of the APA

- The APA procedure fails if
 - the authority in the other State does not initiate the proceedings, or
 - no consistent interpretation of the agreement is achieved, or
 - the taxpayer does not meet the conditions.
- The local tax authority is not bound by the APA if
 - the conditions contained in the APA are not/are no longer met, or
 - the other state does not comply with the APA, or
 - the legislation on which the APA is based is amended or repealed.

§ 89a AO: Other elements of the scheme

- The APA may be extended upon request.
- The APA can be extended to previous periods (roll-back) upon request.

Time of application Art. 97 § 34 EGAO

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Immediately after the announcement of the new law, i.e. for all APA applications submitted immediately.

(4) Administrative Guidelines 2020

Existing TP Guidelines

Existing set of TP Guidelines

- Verwaltungsgrundsätze 1983 / Administrative Guidelines 1983
- Verwaltungsgrundsätze 2005 / Administrative Principles on Procedures 2005

New TP Guidelines

- Verwaltungsgrundsätze 2020 / Administrative Guidelines 2020

Comment

- Unfortunately, the opportunity was not taken to merge the 1983, the 2005 and the 2020 paper into a single document.
- Instead of one, there will now be three documents to be observed.
- A total of 147 pages (!).

Background

- The VG 2020 partially replace the Administrative Guidelines 2005 (VGV 2005), which remain applicable except for the regulations on sections 90 and 162 German Tax Code (AO).
- Chapters 1 and 2 as well as 5 to 7 of the VGV 2005 in particular therefore remain unchanged.
- The VG 2020 are applicable to all open cases with immediate effect.
- Background:
 - OECD Transfer Pricing Guidelines 2017;
 - subsequent changes in section 90 (3) of the AO and the Profit Accrual Recording Ordinance (GAufzV) in the version of 12 July 2017; and
 - the VGV 2005 still contained the old legal status and therefore had to be updated.
- 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 method;
- Request for TP documentation also possible outside of a tax audit in the future; and
- Offers preliminary discussions and reconciliations with the tax authorities.

Obligation to cooperate (1)

- The taxpayer's obligations with regard to data access have been tightened.
- In the future, the obligation to submit data will explicitly apply to e.g. expert opinions and opinions on transfer prices, insofar as they are considered significant for the formation of transfer prices or the determination of income in their context (*by the tax audit*).
- Emails, messenger service messages (e.g. WhatsApp) or other electronic communication media, books, records are mentioned for this purpose.
- Domestic retention periods are transferred to foreign countries (paragraph 11). This is in direct contradiction to Chapter V of the OECD TP Guidelines 2017, according to which in Chapter 5.35 the taxpayer should not be obliged to do this.
- When concluding intercompany agreements, the tax authorities demand the inclusion of information clauses in order to be able to access information from abroad more easily in the future (para. 14).

➡ Much more transparency required

Obligation to cooperate (2)

A proper business manager would reserve the right to submit the following documents:

- a. Evidence of sales prices of a related party distributor to unrelated third parties using the resale price method,
- b. Costing documents of a foreign service company when applying the cost-plus method,
- c. Evidence of the contributions made by the cooperating undertakings in the case of participation in a cost allocation agreement,
- d. Evidence of the revenue generated by the licensee from these assets in the case of the transfer of intangible assets in return for revenue-based royalties; or
- e. Documentation of the total profit or loss and the apportionment formula when using the transaction-by-transaction profit apportionment method.

Obligation to cooperate (3)

- In the case of majority shareholdings or simultaneous management activities in the domestic and foreign company (i.e. personal union), the tax authorities assume, as they did already in the VGV 2005, that these documents can be obtained.
 - The case of a so-called collision of duties of the taxpayer (foreign information prohibitions vs. domestic duty to cooperate under section 90 (2) AO) has also been tightened compared to the VGV 2005 in paragraph 18.
 - According to the VGV 2005, a resulting refusal to cooperate in Germany was still justified; now, according to the VG 2020, it should lead to the possibility of an estimate according to section 162 (1) AO.
 - Numerous indeterminate legal terms such as "certain probability" and "vagueness" are not helpful in clarifying questions of interpretation, such as the question of when the results of an alternative method applied by the tax authorities should be "more probable" (paragraph 46).
- ➔ Previously at least contentious issues have always been clarified at the expense of taxpayers

Language requirements

- Four (!) paragraphs on language requirements, the official language German and possible translations.
- Even the Masterfile, which is only intended to provide a general overview and, according to the OECD's understanding, is actually only to be prepared once per group and has thus basically been given an English-language character, is only to be admitted in English upon application and may have to be translated.

Best method rule

- It is also not further specified how the taxpayer is to demonstrate his genuine effort on the basis of "**objectified circumstances**" with regard to the factual and adequacy documentation (para. 36).
- A **best method rule** in paragraph 45 obliges the taxpayer to explain and justify why it considers the chosen method to be the most suitable method.
- In paragraph 46, 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.

Timing aspects

- The factor "time" plays an essential role in paragraphs 35 and 49: The decisive point in time for the arm's length comparison and for the preparation of records is basically the conclusion of a contract, i.e. the circumstances at the time of the agreement of a business transaction. Therefore, in the future, information must be provided on the time of the transfer pricing determination.
- Subsequently discovered arm's length data can still be used as long as it relates to the time of the transfer pricing determination, i.e. operational price setting/profit checking models that have become very common in practice should therefore continue to work.
- Point 61 provides that in justified individual cases (e.g. mutual agreement procedure), documentation can also be requested outside of a tax audit. In connection with point 64, which recommends a regular and timely collection of data and information, the tax authorities are increasingly pushing for timely transfer pricing documentation.

Power of estimation

- According to paragraph 67, the so-called "Beweisverderber" = " spoiler of evidence" must expect that an appraisal will be carried out.
- The unspecified term "**highest possible probability**" in paragraph 71 is intended to ensure that the tax authorities determine and apply the "**correct**" transfer price in the case of an estimate. According to paragraph 72, database studies should be permissible for estimation purposes. Here, a reference to chapters 3.4.10.2 and 3.4.10.3 of the VGV 2005 would be useful, according to which database studies are only applicable for the company characteristics deemed suitable therein, and not in general.
- Usable records should not be able to prevent the tax authorities from nevertheless demanding further information or carrying out checks (para. 73). Thus, usable records do not exclude estimates. Fishing expeditions to be expected.
- Point 82 explains which criteria are applied to a record in order to classify it as unusable. An opportunity for improvement by the taxpayer is provided for in paragraph 84.

Take away

- Taxpayers should review their transfer pricing documentation for all open years with regard to the new requirements under the VG 2020 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.
- It is regrettable that the German tax administration missed the opportunity to retread the German TP Guidelines.

Thank you very much!

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