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GERMAN TRANSFER PRICING RULES IN PRACTICE

In recent years, the German government and its Finance Ministry have tightened the legislation relating to transfer pricing, seeking not only to offset reductions in the tax rate but also to close the loopholes said to be eroding the German tax base. Historically, transfer pricing was an important issue, primarily with respect to domestic transactions, since German tax authorities focused on the relation of companies to their German resident shareholders rather than on cross-border issues.

LEGISLATION AND ADMINISTRATIVE GUIDELINES

Germany applies the "at arm's length" principle to transactions of related parties. For corporations, this principle is stipulated in Section 8, Paragraph 3, of the Corporation Income Tax Act (*Körperschaftsteuergesetz*) and states that a hidden distribution of profits cannot reduce the taxable income. The term "hidden distribution" is defined by extensive case law and the administrative regulations (*Körperschaftsteuer-Richtlinien*) as a decrease of assets or a prevented increase of assets of a corporation that is caused by the relation of the company to its shareholder and affects the corporation's income. A decrease or prevented increase of profits is based on the relationship of the shareholder to the corporation if a prudent and diligent managing director, under the same facts and circumstances, would not have accepted the decrease or prevented the increase of assets vis-à-vis a person who is not a shareholder.

In 1972, the Foreign Tax Act (*Außensteuergesetz*) was enacted. Section 1 grants the tax authorities the right to adjust a German taxpayer's taxable income from cross-border transactions with related parties if the transactions were not at arm's length. It is clear that Section 8, Paragraph 3, of the Corporation Income Tax Act relates to domestic and cross-border transactions, whereas Section 1 of the Foreign Tax Act relates only to cross-border transactions.

In 1983, the Finance Ministry published its first administrative guidelines.[1] These guidelines include instructions for the application of Section 1 of the Foreign Tax Act, along with a detailed description of the applicable transfer pricing methods. Although most of these guidelines are still in force, in 1999 the part dealing with cost-sharing agreements was replaced with a new letter from the Finance Ministry.[2]

A separate letter from the Finance Ministry, dealing with cross-border employees' secondments, was published in 2001.[3]

In response to the landmark decision of the Federal Fiscal Court[4] that put the burden of proof for a taxpayer's failure to adhere to the arm's-length principle on the tax authority, the legislation was amended accordingly and extensive documentation requirements were introduced in the General Tax Act (*Abgabenordnung*).[5] It should be noted that the Finance Ministry needed more than three years to decide whether or not this decision should be binding in comparable cases. The taxpayer is obliged to prepare and, upon request, to present appropriate documentation with respect to the transactions between related parties. In October 2003, the Finance Ministry enacted the new decree with respect to the details of the documentation obligations.[6]

In 2005, in response to the revised OECD transfer pricing guidelines and the new transfer pricing documentation obligations, the Finance Ministry issued new administrative guidelines.[7] These administrative guidelines partly replace the 1983 Administrative Guidelines. Recently, Section 1 of the Foreign Tax Act was amended by the Enterprise Tax Reform Act 2008. Beginning next year, the taxpayer will be required to use a certain method to calculate the applicable transfer price. In addition, it is stipulated that the transfer of enterprise functions cross-border must be treated as a cross-border transaction and the arm's-length principle must apply. In June 2007, the first draft of a decree on the implication of a transfer of enterprise functions was circulated.

APPLICABLE TRANSFER PRICING METHODS

The German tax authorities historically applied three standard transfer pricing methods, briefly described in the 1983 Administrative Guidelines, that conform to the OECD Guidelines: the comparable uncontrolled price method, the resale price method, and the cost-plus method. It was left to the taxpayer to determine which transfer pricing method was most appropriate in a particular case. However, it was assumed that a diligent manager would apply different methods in order to cross-check the result of the chosen method.

The 2005 Administrative Guidelines, released in response to the revision of the 1995 OECD Guidelines, permit use of the profit split method and the transactional net margin method in addition to the three standard pricing methods. However, these two methods are regarded as a last resort, to be used when the other three methods may not give reliable results. The comparable profit method is still not accepted.

The Enterprise Tax Reform Act 2008 now codifies for the first time which transfer pricing methods have to be applied and the manner in which this must be done. Section 1,

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1. Schreiben betr. Grundsätze für die Prüfung der Einkunftsabgrenzung bei international verbundenen Unternehmen (Verwaltungsgrundsätze) as of February 23, 1983; BStBl 83 I, p. 218 ("1983 Administrative Guidelines").
2. Schreiben betr. Grundsätze für die Prüfung der Einkunftsabgrenzung durch Umlageverträge zwischen international verbundenen Unternehmen as of December 30, 1999; BStBl 1999 I, p. 1122.
3. Schreiben betr. Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen international verbundenen Unternehmen in den Fällen der Arbeitnehmerentsendung (Verwaltungsgrundsätze – Arbeitnehmerentsendung) as of November 9, 2001; BStBl 2001 I, p. 796.
4. Federal Fiscal Court (*BFH*), as of October 17, 2001; Der Betrieb 2001, p. 2474.
5. Steuervergünstigungsabbaugesetz as of May 16, 2003; BStBl 2003 I, p. 660.
6. Verordnung zu Art, Inhalt und Umfang von Aufzeichnungen im Sinne des § 90 Abs. 3 Abgabenordnung. (Gewinnabgrenzungsaufzeichnungsverordnung) as of November 13, 2003; BStBl 2003 I, p. 2296.
7. Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen nahestehenden Personen mit grenzüberschreitenden Geschäftsbeziehungen in Bezug auf Ermittlungs- und Mitwirkungspflichten, Berichtigungen sowie auf Verständigungs- und EU-Schiedsverfahren. (Verwaltungsgrundsätze-Verfahren) ("2005 Administrative Guidelines") as of April 12, 2005; BStBl 2005 I, p. 570.

Paragraph 3, of the Foreign Tax Act stipulates that transfer pricing should be based on the uncontrolled price method, the resale price method, or the cost-plus method. Consequently, other transfer pricing methods, such as the profit split method and the transactional net margin method, should be used only in exceptional cases.

Fully Comparable Data. The law further provides that the taxpayer has to research and present fully comparable third-party data. Such data must be adjusted appropriately in consideration of the functions, the employed assets, and the opportunities and risks. If it is determined that more than one price has been established by this calculation, a couple of potential prices will be considered as a range of prices. If the transfer price used by the taxpayer is outside this range, the median of the range is decisive for the adjustment by the tax authorities. If, on the other hand, the prices used by the taxpayer are within this established range, there is no adjustment by the tax authorities, whether or not the price is equal to the median of the range.

Limited Data. Where the taxpayer is not able to obtain comparable third-party data, he may use limited comparable third-party data that must be adjusted according to the results of the above-described functional and risk analysis. Again, if the actual transfer price of the taxpayer is outside the limited range, the median of the prices is decisive for the tax authority to determine their adjustment. In this respect, the 2005 Administrative Guidelines provide that in cases where no adequate prices could be established, the interquartile method will be used to determine the midpoint for the prices.

No Data. The law further provides that where no third-party data is available, a hypothetical third-party price considering the functional and risk analysis shall apply for the income determination of the taxpayer; the highest price (the view of the purchaser) and the lowest price (the view of the seller) have to be determined. In such case, the price to be used will be the one most likely to be accepted by unrelated parties. If this likelihood cannot be established by the taxpayer, the midpoint has to be used.

Relocation of Functions. The new law further introduces a specific provision relating to the relocation of entrepreneurial functions, including opportunities and risks. It would apply, for example, to the German legislature's recent proposal to tax the relocation of manufacturing functions from Germany to countries that offer lower labor costs.

The law requires that the relocation must be adequately compensated by the recipient, taking into account the chances and risks and the transferred assets, including intangibles (*e.g.*, know-how), as a single package. The value of this "package" has to be calculated by the discounted cash method applying at-arm's-length interest rates.

In cases where no or no material intangible assets are relocated, the taxpayer is permitted to determine the total transfer price on the basis of each individual asset or service. However, this applies only if the total transfer price compared to the transfer price for the package is still at arm's length.

Transfer of Intangibles. The new law introduces the commensurate transfer pricing calculation in cases where intangibles are part of a cross-border transaction. In such cases, the law assumes—although it can be rebutted by the taxpayer—that the parties to the transaction typically do not have complete knowledge of the future business development associated with the transferred intangibles, and a prudent manager will therefore insist on a price-adjustment clause. It is noteworthy that this legal assumption applies only if the factual business development deviates from the expected development. The law further provides that, if no price-adjustment clause is included in the transfer agreement or license agreement and material deviation occurs within the first 10 years of the term of the agreement, the transfer price adjustment has to be made retroactively for the completed fiscal years.

SPECIAL TRANSFER PRICING CASES

Cost-Sharing Agreements. By the end of 1999, the Finance Ministry had circulated a letter dealing with cost-sharing agreements[8] by which the 1983 Administrative Guideline was partly revised. The letter provided that cost-sharing

8. See footnote no. 3.

agreements must be in written form. They must clearly show the benefits and expenses of each party to the agreement. No profit markup is permitted because each party contributes to the pool and receives a right to the results of the work product. The letter further provides details on the required documentation of the expenses and benefits of the pool, the details of other pool members, the right to control and review the expenses of those members, and the details of the chosen proportions. The right to terminate the cost-sharing agreement, as well as the right to demand an adjustment, is also required.

Employee Secondments. In 2001, the Finance Ministry published a letter that provided specifics in the case of employee secondments;[9] it stated that the company has to bear the expenses that have the main interest in the particular secondment. This could be the "seconding employer" if, for example, it is part of the company's international strategy to second employees to foreign countries, if the employee has reporting and controlling functions in the "receiving employer" for the benefit of the "seconding employer," or if the secondment enables a transfer of know-how from the "receiving" company to the "seconding" company. On the other hand, the "receiving employer" has to bear the cost if it needs specific knowledge of such employee or if it prefers to train the employee for its own benefit. All this must be recorded, as well as the details of the employee's remuneration and associated costs. The letter further provides that the recharges of the "seconding employer" to the "receiving employer" have to apply the comparable uncontrolled price method in the first instance. Therefore, it has to be determined what expenses would have been incurred if the employer had hired a person with the same knowledge and capabilities locally. These comparable expenses are the upper limit of what the receiving company can be recharged for.

DOCUMENTATION REQUIREMENTS

Documentation. The documentation obligations are qualified in Section 90 of the General Tax Act. The legislation, enacted in 2003,[10] stipulates the obligation of the taxpayer to clarify transactions that occurred outside Germany and to deliver the required supporting evidence. The taxpayer is obliged to use all existing legal and factional options to achieve this, since the burden of proof is on him. He cannot argue that he is unable to clarify the facts or provide evidence if he would have been in a position to do so beforehand.

It is further stipulated that the taxpayer in a cross-border transaction is obliged to record the type and content of the business transaction to related parties. The documentation includes the economic and legal basis of the arm's-length principle with respect to pricing and other business terms. On request, the documentation has to be delivered to the tax authorities within 60 days. For extraordinary business transactions[11] like restructurings or the conclusion of long-term agreements, the documentation has to be set up promptly, which is defined to be within a six-month period of the conclusion of the fiscal year. In the case of extraordinary business transactions, the period of document production is reduced to 30 days. The period can be extended upon petition by the taxpayer.

Based on Section 90 of the General Tax Act, the Finance Ministry enacted a decree[12] that provides details on how the evidence has to be provided and what documentation is required. Further details are included in the 2005 Administrative Guidelines. In general, the documentation must be based on the respective transaction, but it is permissible to group comparable transactions if such grouping is determined before the incurrence of the transaction.

To the extent possible, the taxpayer is obliged to collect comparable publicly obtainable data supporting the transfer pricing method applied by him. In particular, the taxpayer has to document comparable data resulting from his own third-party transactions, *e.g.*, pricing, general terms and conditions, cost quota, profit margin, cross margin, net margin, and profit split.

The records have to comprise (i) general information about the group and ownership's structure, the business and group

9. See footnote no. 2.
10. See footnote no. 5.
11. The definition of "extraordinary business transaction" was revised and further broadened by the Enterprise Tax Reform Act 2008.
12. See footnote no. 6.

organization, (ii) business relations to related parties, (iii) analysis of functions and risks, and (iv) transfer pricing analysis. Some of the information must relate to a general overview, consisting of group structure charts and the type of business (*e.g.*, distribution, manufacturing services, etc.). Other records must show the type and extent of the business conducted with related parties (*e.g.*, purchases, sales services, financing, and other use of assets). In particular, the records must include the material intangible assets owned by the taxpayer and that he has licensed to related parties. The functional and risk analysis must record the function and the associated risk of the taxpayer and the related parties within the particular business transaction. It must further record material assets, the business strategy, and relevant market and competition relations and situations. Finally, the chosen transfer pricing method, the explanation of the appropriateness of the chosen transfer pricing method, calculation records, and data about comparable third parties should be documented. The 2005 Administrative Guidelines provide a more detailed list of the information the taxpayer has to record.

Penalties. If the taxpayer does not produce the records or the records are unusable, or if it is recognized that the records have not been set up in due time, it will be assumed that the income of the taxpayer is higher than reported (although the taxpayer is permitted to rebut this legal assumption). The tax authorities are permitted to estimate the income at the upper level if there is a range of possible "correct" incomes.

The taxpayer has to pay a penalty of at least €5,000 if he does not produce the documentation or if the documentation is unusable. The penalty will be 5 to 10 percent of the additional income that is assessed as a result of the nonproduction of the records, if this amount exceeds €5,000. If the documentation is produced after the 60-day/30-day period, a minimum penalty of €100 per day will be due, up to €1 million.

ADVANCE PRICING AGREEMENTS

In 2006, the first letter of the Finance Ministry regarding advance transfer pricing agreements ("APA") was published.[13] Under German law, no agreements between the taxpayer and the tax authorities are permitted. Nevertheless, the German tax authorities are interested in APAs because they believe it is easier to share in the international "tax cake" at the outset rather than try to participate in a controversy after the fact.

In the German context, the international common understanding of an APA cannot be translated into German law. As stated, the law does not permit an agreement between the taxpayer and the tax authorities. Therefore, the German Finance Ministry elaborates the elements of an APA from a German perspective as follows: The APA is an advance competent authority agreement between the German competent authority and the relevant foreign competent authority. In addition, it is a request for a binding ruling by the taxpayer that implements the intergovernmental agreement.

In this context, it is evident that the competent authority procedure is based on a double tax treaty with the relevant foreign country. Consequently, no APA could be obtained in relation to a foreign country with which no double tax treaty is in force. In such cases, the APA, as understood in Germany, simply lacks a legal basis. Nevertheless, since Germany has a broad treaty network, the practical impact should be limited.

The APA procedures are centralized at the Federal Central Tax Office (*Bundeszentralamt für Steuern*), where the application for the APA has to be filed; centralization seems to be more efficient, as each local tax office has to deal with international issues. Please note that the Federal Central Tax Office will not agree with a foreign competent tax authority if the local or state tax authority does not approve such agreement.

As stated above, the first part of the APA procedure is an agreement between the German and foreign tax authorities. Nevertheless, the taxpayer has to initiate the procedure. He has to file an application by which he determines the scope and limits of the intergovernmental negotiations and agreements. He has to provide all relevant facts for both tax authorities. In addition, he has to consent to the result of the negotiations and has to waive all rights to complain before

13. Merkblatt für bilaterale oder multilaterale Vorabverständigungsverfahren auf der Grundlage der Doppelbesteuerungsabkommen zur Erteilung verbindlicher Vorabzusagen über Verrechnungspreise zwischen international verbundenen Unternehmen (so-called "Advance Pricing Agreements"—APAs), as of October 5, 2006; BStBl 2006 I, p. 594.

the intergovernmental agreement becomes valid (although he can withdraw from the process at any time). Before the intergovernmental negotiations start, the taxpayer has to pay €20,000. This amount can be reduced to €10,000 in some cases.

It is expected that an intergovernmental agreement will have an effective period of three to five years. Upon application and approval by the foreign tax authority, the term of the APA can be extended. A fee of €15,000 will be due, which might be reduced to €7,500.

The content of an APA is limited to transfer pricing issues. The taxpayer has to outline the scope of the requested APA. Further, he has to describe in detail the facts and circumstances, the applicable transfer pricing method, and the calculations that verify the results of the applicable transfer pricing method, and he must provide supporting documentation.

In cases where the taxpayer has obtained an APA in a foreign country, the German tax authorities are not bound by such unilateral APA. Moreover, the German tax authorities might audit the taxpayer because it is assumed that the taxpayer has concluded an agreement with a foreign country to the disadvantage of Germany.

If a taxpayer files an application for an APA procedure, he must be aware that any facts and circumstances he presents within the APA procedure could be used by a local tax authority in determining its tax, particularly in cases where no APA is achieved.

PROCEEDINGS

Administrative Appeal. Transfer pricing adjustments are the typical result of a tax audit. Depending on the size of the company, all fiscal years will be subject to audit. Tax auditing is a standard procedure and takes place every three to four years. The audit ends with a final discussion between the tax authorities and the taxpayer; in most cases, an agreement to the proposed revisions of the tax authorities will be achieved. The results of the audit will be summarized in an audit report, which serves as a basis for the revised tax-assessment note.

Irrespective of whether an agreement was achieved during the audit, the taxpayer has the right to appeal the assessment note. The appeal must be filed with the local office that issued the revised tax-assessment note, and the taxpayer should give reasons and provide evidence. The tax office will render a decision on the appeal in writing, stating the reasons for its decision.

At the same time, the taxpayer may apply for a competent authority proceeding. If he does so, the administrative appeal will be on hold until the case is resolved by the competent authorities.

Juridical Appeal. If the taxpayer's administrative appeal is rejected, he has the right to file a claim with the lower tax court (*Finanzgericht*), whereby the taxpayer brings an action against the local tax office that issued the disputed tax-assessment note. It is a tax court's right and duty to review all facts and circumstances as well as the legal consequences of the case. The tax court is not restricted to dealing with the arguments and facts brought forward by the taxpayer or the tax office, but may also take into consideration all facts and circumstances of the case, including facts that are new to the taxpayer or the tax office. The lower tax court renders its decision in writing. This decision can be appealed only if (i) the legal issue is of fundamental significance, (ii) the lower fiscal court violated the rules of procedure and the disputed decision is the result of this violation, or (iii) the uniform interpretation of the law requires a decision of the Federal Fiscal Court.

If the Federal Fiscal Court approves the appeal as being correct in form and content, it commences proceedings. In doing so, it will not review the facts and circumstances of the case—only the legal issues, based on the facts established by the lower fiscal court. The decision of the Federal Fiscal Court is not appealable but can be brought up to the Federal Constitutional Court. However, this is the case only if the decision of the Federal Fiscal Court is based on a law that is unconstitutional. In other exceptional cases where the taxpayer believes that the decision of the Federal Fiscal Court violates European law, he may appeal to the European Council Court of Justice.

COMPETENT AUTHORITY PROCEDURES

The taxpayer can apply for the competent authority procedure at any time, provided he can claim that the action of the tax authorities will result in a taxation that violates the applicable tax treaty. The double taxation that can result from the adjustment of transfer prices is regarded as such a treaty violation.

It should be noted that the taxpayer can apply for the competent authority procedure, but according to most of the tax treaties to which Germany is a party, the taxpayer has no right to enforce the achievement of an agreement between the relevant tax authorities. With respect to the new German-U.S. double tax treaty, this will change once a new treaty is effective.

ARBITRAGE

The EU-Arbitrage Convention[14] entered into force in 1995 for a five-year period. It was extended for a further five-year period in 2000 and again on January 1, 2005. In the meantime, a new convention was proposed, which will become effective after all 25 EU member states have ratified it. However, it contains a provision permitting the member states to apply the new convention on a bilateral basis if it is not unanimously approved.

The convention applies where the profits of a taxpayer who resides in a member state are included in the profits of the resident of another member state, resulting in double taxation because neither of the parties had observed the arm's-length principle. It should be noted that the EU Convention does not apply to a taxpayer resident in the U.S. However, it does apply to European resident subsidiaries of the U.S. group among the European group companies.

Resolution of the transfer pricing dispute may require three steps. In the first step, the taxpayer has to inform its foreign related party, which in turn informs its competent authority. If the foreign company and the foreign competent authority agree to the adjustment, the procedure is final. If they don't agree, formal procedures begin. In the second step, the competent authorities have to agree within two years. Otherwise, they have to set up an advisory commission that has to deliver an opinion within a further six months. In the third step, which applies only if the competent authorities do not agree with the advisory commission, the parties are given another six months to reach an agreement. Otherwise, they have to act according to the advisory commission's opinion.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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14. Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, 90/436/EEC; Official Journal L 225 as of August 20, 1990, 10.