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RESOLVING TRANSFER PRICING DISPUTES

A Global Analysis

Edited by

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and

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To our families,
B, J, A and J; K and M

Transfer pricing in Germany

ANDREAS OESTREICHER

6.1 Introduction

This chapter provides an analysis of dispute resolution procedures in the area of international profit attribution as seen from the perspective of the Federal Republic of Germany. It will become apparent that in this country, differences of opinion existing with regard to transfer pricing can in many cases be resolved by means of a kind of consensus between the taxpayer and the tax authorities. There is a tradition of legal provisions designed to prevent international profit shifting using inappropriate contractual arrangements in the case of substantial participation in a foreign company. But the number of judgments actually handed down by the German Bundesfinanzhof (Federal Tax Court) dealing with 'adjustment of income' (section 1 of the German Foreign Tax Act) resulting from disputes in the area of international profit attribution is surprisingly low. Although the number of rulings with respect to 'hidden profit distributions' and 'hidden capital contributions' concerning a shifting of profits between a company and its shareholders in the primarily domestic scene appears infinite, in the international transfer pricing domain it is much more common for the taxpayer and the tax authorities to come to an agreement out of court ('tax audit bazaar'). Such an agreement between taxpayer and tax authorities does not, however, guarantee freedom from double taxation. In order to prevent the occurrence of double taxation in this context, German taxpayers increasingly turn to the bi- or multilateral dispute resolution possibilities employing mutual agreement procedures and advance pricing agreements. Only in recent years has the German tax administration been giving these procedures their active support.

This chapter is structured as follows. After a brief round-up of the economic and institutional context of transfer pricing in Germany, section 6.3 will set out the historical background of the German transfer pricing rules. Section 6.4 sums up the main aspects of Germany's

transfer pricing legislation. Against the background of these introductory considerations, the core topic of this contribution is dealt with in sections 6.5 to 6.7. The domestic approaches to resolving transfer pricing disputes in Germany are discussed in section 6.5, while section 6.6 complements the domestic view with a survey of bilateral and multilateral approaches. In section 6.7 advance pricing agreements are explored. The chapter is rounded off with some concluding remarks.

6.2 Economic and institutional context

Germany is regarded as having the highest-performing economy in Europe. Taking GDP as the basis, in 2010 Germany occupied fourth position in the worldwide comparison. In that year its GDP amounted to 2,497.6 billion euro.¹ Among the most essential reasons for Germany's strong performance are high productivity of labour, a first-class infrastructure in an advantageous setting within the EU, and marked innovatory strength associated with a high percentage of research-intensive industries, above-average spending on research and development, numerous patents and world leading sectors both in terms of market volume and growth potential (information and communication, the chemical industry and plastics, transport and logistics, photovoltaic and medical technology). Adding to these factors are legal certainty, an efficient legal system and a transparent, independent judiciary. A fact also of relevance to foreign investors is that Germany constitutes a market consisting of more than 80 million consumers (20 per cent of the European market), disposing over a high per capita income. Based on a per capita purchasing power of 19,684 euro (2010), Germany ranks among the top ten countries in the European comparison.

The German economy is focused on industry-produced goods and services, whereas raw materials and agricultural production are of only minor economic significance. The major trading partners are other industrialised countries, a considerable overall surplus arising from foreign trade. In 2010 the rise in German exports ran into double figures. 2011 is exhibiting a similarly dynamic development in this respect. Specialised products of high quality secure the position of German companies in their particular export markets. Among the most important

¹ Statistisches Bundesamt, Gross domestic product 2010 for Germany, supporting documentation for the press conference on 12 January 2011 in Wiesbaden.

export products are those of the automobile industry while raw materials for energy generation figure most strongly on the import side.

Consolidated German (directly and indirectly) held investments abroad (stock of FDI assets, all sectors, in million euros) are shown in Table 6.1.

German investments in further European countries such as the Netherlands, Belgium, Luxembourg, France and Italy follow in this order with smaller investment volumes.²

Consolidated foreign (directly and indirectly) held investments in Germany (stock of FDI liabilities, all sectors, in million euros) are shown in Table 6.2.

Again, foreign investments by further European countries follow with smaller investment volumes. In the case of foreign direct investment

Table 6.1 Consolidated German (directly and indirectly) held investments abroad

| Stock of FDI assets, all sectors (in million euros) | Per cent of GDP | | Per cent of GDP | | Per cent of GDP | |
|---|--------------------|------|--------------------|------|--------------------|------|
| | 2007 | 2008 | 2008 | 2009 | 2009 | 2009 |
| Total | 904,661 | 37.3 | 953,505 | 38.3 | 984,540 | 40.9 |
| EU 27 | 504,263 | 20.8 | 542,943 | 21.8 | 561,610 | 23.4 |
| United States | 207,578 | 8.6 | 211,607 | 8.5 | 217,040 | 9.0 |
| United Kingdom | 119,761 | 4.9 | 99,679 | 4.0 | 120,894 | 5.0 |

Table 6.2 Consolidated foreign (directly and indirectly) held investments in Germany

| Stock of FDI liabilities, all sectors (in million euros) | Per cent of GDP | | Per cent of GDP | | Per cent of GDP | |
|--|--------------------|------|--------------------|------|--------------------|------|
| | 2007 | 2008 | 2008 | 2009 | 2009 | 2009 |
| Total | 472,453 | 19.5 | 479,808 | 19.3 | 469,745 | 19.5 |
| EU 27 | 348,824 | 14.4 | 358,915 | 14.4 | 361,422 | 15.0 |
| United States | 54,186 | 2.2 | 47,242 | 1.9 | 36,133 | 1.5 |
| The Netherlands | 105,501 | 4.4 | 107,962 | 4.3 | 110,621 | 4.6 |

² Deutsche Bundesbank/Eurosystem, Survey on direct investments, Special publication: Statistics, 10 April 2011, p. 6 *et seq.*

(FDI) liabilities, these countries are Luxembourg, the United Kingdom, France and Italy (in this order).³ These figures place Germany sixth in the UNCTAD ranking 2009, characterising Germany as an investment location of worldwide significance. In the years 2000 to 2009, FDI liabilities rose annually by an average of 5 per cent. The leading important sectors for foreign investment include information and communication technology, software, services, motor vehicles, engineering and the chemical industry.

Germany's favourable location conditions do have their price. Besides a major share in the federal budget that is spent on social security (54.2 per cent), the largest items on the budget agenda are general services (17.0 per cent), business enterprises⁴ (5.12 per cent), education and research (4.8 per cent) and transport and telecommunications (3.9 per cent)⁵ which are financed to a very great extent by taxes. Accordingly, in 2010 federal expenditure amounting to 303.7 billion euros was funded by tax revenue totalling 226.2 billion euros, administrative income of 33.1 billion euros, coin income of 0.3 billion euros and a net borrowing of 44.0 billion euros.⁶ These figures illustrate the importance of taxes in funding federal expenditure and Germany's international competitiveness.

The role played by federal taxes (above all consumer taxes) in the federal tax revenue as a whole (article 106 I of the Basic Law (Grundgesetz, GG)) is relatively small (36.1 per cent). A greater role in the federal tax revenue is played by the taxes accrued jointly to the Federation, the Länder, and the municipalities (income tax, corporate income tax and value added tax) and the federal share in the trade tax (making up 74.2 per cent in total).⁷ The joint taxes (article 106 III GG), Länder taxes (article 106 II GG) and the municipal taxes (article 106 VI GG) also serve to finance tasks allocated by the German Basic Law to the Länder and the municipalities (article 104a GG), with the result that with regard to the significance of tax in Germany the development of total tax revenue in the Federal Republic is of interest. This total tax revenue is created in the Federal Republic from a total of more than 40 individual types of tax, which generate significant levels of revenue only in part. Important types of tax in the area of direct taxation are in particular

³ *Ibid.* p. 42 *et seq.* ⁴ These enterprises operate primarily in the transport sector.

⁵ Federal Ministry of Finance, Overview of the Federal Budget 2010, p. 17 *et seq.*

⁶ Federal Ministry of Finance, Press Communication No. 1/2011, 13 January 2011.

⁷ Please note that negative income from EU payments is to be deducted; in 2010 this amounted to 11.3 per cent of the Federal Republic's tax revenue.

Table 6.3 Development of German tax revenue 1970 to 2010*

| | 1970 | 1980 | 1990 | 2000 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|------------------------------|---------------|---------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Income tax | 26.0 (7.2) | 75.8 (9.6) | 109.1 (8.3) | 147.9 (7.2) | 129.3 (5.9) | 128.7 (5.8) | 140.2 (6.1) | 156.8 (6.5) | 174.6 (7.0) | 161.6 (6.7) | 159.1 (6.4) |
| Corporate income tax | 4.5 (1.2) | 10.9 (1.4) | 15.4 (1.2) | 23.5 (1.1) | 13.1 (0.6) | 16.3 (0.7) | 22.9 (1.0) | 22.9 (0.9) | 15.9 (0.6) | 7.2 (0.2) | 12.0 (0.5) |
| Value added tax | 19.5 (5.4) | 47.8 (6.1) | 75.5 (5.8) | 140.8 (5.1) | 137.4 (6.3) | 139.7 (6.3) | 146.7 (6.3) | 169.6 (7.0) | 176.0 (7.1) | 177.0 (7.4) | 180.0 (7.2) |
| Trade tax | 5.5 (1.5) | 13.9 (1.8) | 19.8 (1.5) | 27.0 (1.3) | 28.4 (1.3) | 31.0 (1.4) | 38.4 (1.7) | 40.1 (1.7) | 41.0 (1.6) | 32.4 (1.3) | 34.6 (1.4) |
| Mineral oil and energy taxes | 5.9 (1.6) | 10.9 (1.4) | 17.7 (1.4) | 37.8 (1.8) | 41.8 (1.9) | 40.1 (1.8) | 39.9 (1.7) | 39.0 (1.6) | 39.2 (1.6) | 39.8 (1.7) | 39.8 (1.6) |

* Figures in billion euros. The figures in brackets indicate the level of revenue as a percentage of GDP.

income tax, corporate income tax and trade tax. As far as indirect taxes are concerned, value added tax and taxes on mineral oil and other sources of energy produce the highest revenue. The development of tax revenue over the past thirty years is shown in Table 6.3 (in billion euros).

As can be seen from Table 6.3, income tax and value added tax carry the greatest weight in this context. Income tax is due on income of natural persons having their residence or habitual place of abode in Germany. This group of taxpayers includes sole traders and partners in a partnership with business operations. Value added tax is payable on goods and services within Germany, import of goods and intra-community acquisitions. Corporate entities and, in particular, companies limited by shares, are subject to corporate tax. Their contribution to total tax revenue is low, amounting to approximately 0.5 per cent of GDP. However, this figure should not lead to the conclusion that the correct determination of income with respect to these companies (including examination of transfer prices *vis-à-vis* affiliated companies) is of subordinate significance. Correct determination carries significance for reasons of equal taxation of companies operating in the legal form of limited companies and sole traders and partnerships alone.

Intra-group transfer pricing also features centrally in Germany because cross-border business activities are carried out primarily by enterprises in the legal form of limited companies. Taking the information provided in financial statements as a basis, foreign direct investments are carried out first and foremost by limited companies (93.9 per cent of all companies involved), whereas only a small fraction of the relevant shareholdings are held by partnerships (6.1 per cent). In both cases, the lion's share of these assets is held by large enterprises. Here, the number of limited companies accounts for 86.1 per cent, whereas the relevant fraction is 5.1 per cent in the case of partnerships.⁸ In this context, Table 6.4 illustrates the volume of German FDI in terms of the number and size of FDI companies.

As far as FDI liabilities are concerned, the share of investments carried out in the legal form of a limited company is even higher (95.4 per cent), whereas the number of partnerships held by foreign investors accounts for only 4.6 per cent. As a result, it emerges that tax transfer pricing may exercise a large impact on corporate tax revenue in the first instance. Moreover, since corporate tax revenue is derived from a relatively small

⁸ Bureau van Dijk, Database AMADEUS, update 172, 2009.

Table 6.4 *Volume of German FDI in terms of the number and size of FDI companies*

| | Number of companies | Net equity | Balance sheet total | Sales revenues |
|---------------------------------------|---------------------|------------|---------------------|----------------|
| Directly held FDI ^a | 20,156 | 40.7 | 241.6 | 43.5 |
| Indirectly held FDI | 11,118 | 50.1 | 187.0 | 81.2 |
| German limited companies ^b | 59,072 | 9.38 | 32.03 | 46.39 |

^a Deutsche Bundesbank/Eurosystem, Survey on Direct Investments, Special publication: Statistics, 10 April 2011, p. 6 *et seq.*; this information refers to the year 2009.

^b Deutsche Bundesbank, Verhältniszahlen aus Jahresabschlüssen deutscher Unternehmen von 2007 bis 2008, März 2011 (Ratios taken from financial statements of German enterprises 2007 to 2008); the year referred to here is 2007.

number of enterprises, the focus is on large companies. Corporate tax statistics show that approximately 10 per cent of all German limited companies contribute some 90 per cent of the corporate tax budget.⁹

6.3 Historical background of transfer pricing rules

6.3.1 Beginnings in Germany

In the international context, the prime purpose of tax transfer prices today is to attribute tax jurisdiction between or among contracting states. Their goal is to avoid the shifting of enterprises' profits to affiliated companies subject to taxation in a different jurisdiction. In Germany, the topic 'shifting profits abroad' was already dealt with in income tax legislation dating from 1925 and 1934. Section 33 of the Income Tax Act (ITA) 1925 reads:¹⁰

- (1) If, as a result of special agreements between the taxpayer and a party not subject to unlimited taxation, the profit of a domestic trade or business is clearly not in proportion with the profit that would otherwise be achieved in business transactions of comparable or similar nature, said profit, or at least the usual return on capital

⁹ Statistisches Bundesamt, Corporate Tax Statistics 2004.

¹⁰ German Reichstag, Drucksache dated 27 April 1925 III 1924/25 No. 795, *Reichssteuerblatt* (*German Tax Gazette*, RStBl) 1925, 196.

serving this trade or business, can be taken as the basis for determining the income of the domestic trade or business. In the meaning of this provision, in addition to fixed assets, capital is deemed to include also current assets, in particular goods, products, and inventory.

- (2) The provision given in section 1 of ITA 1925 does not apply if the taxpayer provides evidence that neither does he hold a share in the assets or profit of the foreign trade or business, nor does the owner of said foreign entity participate significantly in the profit or the assets of his trade or business.

Application of these provisions had proven inadequate, since in part they entailed processes that took place mainly abroad. As a consequence, they failed to be effective in cases where the taxpayer was not willing to cooperate in terms of clarifying details of events possibly incurring taxation. A further practical difficulty was that it was also necessary to determine profits that would have accrued without these particular foreign relationships.¹¹ It was the intention of section 30 of the ITA 1934 to overcome these difficulties by simplifying considerably the preconditions and implementation. It reads:

Taxation in the event of foreign business connections: The tax authorities of the German federal state (Land) can, in the case of income from agriculture and forestry, from trade or business, or from self-employment, determine the income tax as a fixed amount without reference to the result reported, if particular direct or indirect connections of the trade or business to a person who is either not subject to domestic taxation or only subject to limited domestic taxation make a reduction of profit possible. The authorities of the German federal state decide in their own discretion.

According to the grounds stated for this legislation, by virtue of being placed under the discretion of the tax office at the level of the Land (federal state), this provision grants these offices an additional competence. This discretion was to be exercised in such a way that the Reich (Germany) received as income tax any portion of the profits to which it was rightfully due. For these purposes, the provision was only to be applied in cases where there were indications that the profit had indeed been reduced. This provision was not to be applied if the actual business situation called for profit reductions of this kind (for example, as a consequence of 'export prices set strategically for market penetration

¹¹ Reichsfinanzministerium, Explanations regarding the Income Tax Act of 16 October 1934, published in *Reichsgesetzblatt* (*German Law Gazette*, RGBl) I 1934, 1005, Berlin, 8 January 1935, RStBl No. 3, 1935, 48.

purposes'). Unlike the previous regulation which only referred to income from trade or business, the specific taxation of foreign business transactions according to section 30 of the ITA 1934 had also to be applied to income from agriculture and forestry as well as to profit income accruing to self-employed persons (i.e., all types of profit income).

In 1938, the Reichsfinanzhof (Supreme Tax Court) had to hand down a ruling on the prerequisites of the 'fixed amount taxation' in the case of foreign business relationships according to section 30 of the ITA 1934. Here, the tax office entrusted with the case (the tax office at the level of the federal state) came to the conclusion that the profits of the company involved were noticeably lower than the results achieved by comparable companies. Moreover, they saw a possibility that shifting of profits abroad had taken place by way of specific transfer pricing. The German Tax Court confirmed that based on the wording of the law, the tax office was not required to provide evidence that such a shifting of profits had indeed taken place if this was deemed probable according to 'experience of life'. The court, however, ruled the taxpayer was entitled to provide evidence to the contrary. It thus pointed out that the tax office was not permitted to 'ignore without more ado' the evidence that might counter its conclusions.¹² As a consequence the German Tax Court handed back the case to the tax office for further deliberation.

In applying these limitations to the provisions of section 30 of the ITA 1934 the Supreme Tax Court was approaching the principles that still govern the way in which estimates for tax purposes have to be carried out in Germany today. The more difficult it is for the tax authorities to identify without doubt the basis for taxation, the stricter the demands made on the taxpayer to contribute information leading to clarification of the case. It was, and remains, incompatible with the principles of equal taxation, however, to base taxation in the form of a fixed amount only on the condition that a profit reduction might have taken place as a result of foreign business relationships, irrespective of whether any profit reductions actually occurred.

Nevertheless, for reasons of legal protection, the German Bundesfinanzhof (Federal Tax Court) found in 1959 that section 30 of the ITA 1934 was not compatible with the Basic Law of the Federal Republic of Germany as later enacted.¹³ For the German Federal Tax Court, the

¹² Cf. Reichsfinanzhof, ruling of 21 December 1938 VI 537/38, RStBf 1939, 308.

¹³ Bundesfinanzhof, ruling of 7 April 1959 I 2/58 S, *Bundessteuerblatt* (Federal Tax Gazette, BStBl) III 1959, 233.

specific nature of this provision lay not only in the fact that the tax (rather than the profit) was to be determined by way of estimates. It regarded it as being of greater significance that tax assessment was shifted from the local tax office to the tax office of the federal state. The consequence of this shift of competence to the tax office of the federal state (now Oberfinanzdirektion, regional fiscal office) was that the taxpayers' recourse to the law was reduced. The only possibility available was appeal to the German Federal Tax Court. The task of this highest Federal Court is scrutinising decisions only with respect to proper application of the law, whereas it is not entitled to undertake its own evaluation of the actual facts of the case. Since recourse to the law in Germany requires at least one appellate instance entitled to examine whether the actual facts and circumstances of a case have been properly taken into account (article 19(4) of the Basic Law) the German Federal Tax Court found section 30 of the ITA 1934 to be no longer applicable. The authority of the German Federal Tax Court for non-application of this provision arose from the fact that it was promulgated prior to the enactment of the Basic Law and had not been subject to further parliamentary debate since.

6.3.2 Development of current rules

At the same time, the tax differentials between the Federal Republic of Germany and 'some states'¹⁴ presented strong incentives to use special structuring measures in the international arena to produce tax advantages that could not be effectively countered via the law applicable at that time in Germany. Combating the exploitation of unjustified tax advantages was also held back by the fact that the German tax authorities' sovereign powers of investigation did not extend beyond the German borders and the low-tax states concerned steadfastly rejected the idea of concluding agreements on administrative and legal assistance or providing other states with tax information. In a report of the German Federal government to the German parliament explicitly naming the tax differentials *vis-à-vis* Switzerland and Liechtenstein, Luxembourg, the Bahamas, Bermuda, the Netherlands Antilles and Panama, these attempts to circumnavigate unlimited liability to taxation were

¹⁴ Report of the Federal Government to the German Bundestag of 23 June 1964 on the distortions of competition arising from transfer of seat abroad and from tax differentials between states, German Bundestag, Drucksache IV/2412, 25.

registered. Moreover the observation was made that relocation of income and assets had increased also due to the fact that income was being shifted to base companies abroad with the help of tax transfer price planning.¹⁵

The finance ministries of the German Länder reacted to this report from the German government by issuing a coordinated decree, with the same wording in each case (Steueroasenerlass, Tax Haven Decree).¹⁶ According to this decree, in the event of income or assets being shifted to associated companies or other independent legal entities in tax haven countries by persons subject to unlimited tax liability, the tax authorities were asked to scrutinise whether the contracts, business transactions or asset transfers as reported indeed corresponded to the facts of the case. If not, they could not be recognised for tax purposes. This order was to be applied in particular if there was no exchange of goods or services. It referred, however, explicitly also to those cases in which remuneration was paid or received for goods or services in an amount exceeding or falling below the amount an independent third party would have paid or demanded.

As this order to correct profits lacked the necessary legal basis, however,¹⁷ the finance ministry called for preparation of a legal regulation. This took as its basis a report by the Tax Reform Commission on the tax law pertaining to foreign transactions¹⁸ which culminated in a German governmental resolution on 'principles for a law to preserve tax equality within foreign business connections and to enhance the situation with respect to tax competition in the context of investing abroad.'¹⁹ These principles formed a first basis for the later enacted legal

¹⁵ *Ibid.* 10, 13 *et seq.*, 19 *et seq.*, 21, 23 *et seq.*

¹⁶ Cf. e.g., Decree of the Finance Minister of Lower Saxony of 14 June 1965 S 1301-99-31 1, BStBl II 1965, 74.

¹⁷ Cf. Wassermeyer, in Flick, Wassermeyer and Baumhoff, *Kommentar zum Außensteuerrecht*, 1973/2009, s. 1 of the Foreign Tax Act (FTA) No. 18.

¹⁸ See Federal Ministry of Finance, *Report by the Tax Reform Commission on the Tax Law Pertaining to Foreign Transactions*, Issue 16 (Bonn, 1970); this Tax Reform Committee came to the conclusion that the national tax provisions which are based on the legal relationship of domestic enterprises had proved to be insufficient for correct taxation of foreign enterprises with interests in Germany; for business transactions between a domestic enterprise and a controlled foreign corporation, an appropriate correction on request was already guaranteed by law already in force. But it was seen as necessary to impose by way of procedural legislation a more extensive duty to provide information and evidence on domestic shareholders in foreign corporations, see *ibid.* p. 38 *et seq.*, p. 66 *et seq.*

¹⁹ These principles and grounds for the legislation can be read, for example, in *Der Betrieb* 1971, 16 *et seq.*

provisions on 'adjustment of income' (section 1 of the Act on Taxation in respect of Connections Abroad (Foreign Tax Act), Gesetz über die Besteuerung bei Auslandsbeziehungen (Außensteuergesetz) (FTA)).²⁰ Section 1 of this regulation reads:

- (1) If the income of a taxpayer from foreign business relationships with a related party has been reduced, in that within the framework of such foreign business relationships he agrees terms other than those on which mutually independent third parties would have agreed in similar or comparable circumstances, it is to be adjusted, other provisions notwithstanding, to that which would have resulted from those terms as would have been agreed between mutually independent third parties.

Two further sections state:

- (a) the conditions deeming the parties to be 'related'; and
- (b) that a necessary estimate is to be based, in the absence of other appropriate indications, on the interest on the capital employed in the business or the net profit on turnover normally to be expected under usual circumstances.

While the conditions deeming the parties to be 'related' continue to apply today without any change, the regulations applying to estimates were revised with effect from the 2008 assessment period. The new version of the law makes it clear that in assessing the net profit on turnover normally to be expected, or the interest on the capital employed in the business, the functions carried out, the assets employed and the risks assumed have to be taken into consideration.

Over the course of time, the norm has also been subject to changes with respect to its scope of application. On the one hand, Bundesfinanzhof rulings concerning the term 'business relationship' caused the legislator to regulate which transactions are covered by the norm. On the other hand, changes also arose with respect to the type of income involved. Whereas in this connection the norm was originally applicable to relationships forming part of an activity carried out independently, sustainably, with the intention of achieving profit, and within general business operations (not applicable to 'private' loans of a natural person

²⁰ Gesetz zur Wahrung der steuerlichen Gleichmäßigkeit bei Auslandsbeziehungen und zur Verbesserung der steuerlichen Wettbewerbslage bei Auslandsinvestitionen, Law to preserve tax equality within foreign business connections and to enhance the situation with respect to tax competition in the context of investing abroad of 8 September 1972, BGBl I 1972 No. 98, 1713.

holding their participation in the foreign corporation in private property),²¹ in 1992 the legislator inserted a further section (section 4, now section 5) in which the term 'business relationship' was defined.²² This determined that a business relationship in the sense of section 1 of the FTA must lead to income from business activities (agriculture and forestry, sale or trade or self-employed activity) or rent or lease either on the part of the taxpayer or on that of the related party.

The German Federal Tax Court's interpretation of the norm, according to which business relationships do not include such transactions leading to the fact that the domestic taxpayer and the foreign corporation constitute related parties, gave rise to a further change. As a consequence, the German Federal Tax Court regarded the assumption of guarantees without remuneration or interest-free loans of a German parent company to its foreign subsidiary as not fulfilling the prerequisites of a business relationship if, according to the foreign company law, the guarantee or loan was to be deemed equity (substituting for equity).²³ Where this was not the case, granting an interest-free loan could be treated as a business relationship.²⁴ In order to cover all business relationships contractually agreed, the definition of the term 'business relationship' was extended in 1993 such that it now covers 'any contractual relationship affecting income, other than an agreement between a company and its shareholders'.²⁵ Accordingly, it is essential that apart from the shareholding there is an exchange of goods or

²¹ Cf. Bundesfinanzhof, ruling of 5 December 1990 I R 94/88, BStBl II 1991, 287; however, where business loans are concerned, this regulation was and continues to be applicable even in the case that the income of the foreign controlled company is taxed at the level of its parent company (application of CFC rules), cf. Bundesfinanzhof, ruling of 19 March 2002 I R 4/01, BStBl II 2002, 644.

²² Gesetz zur Entlastung der Familien und zur Verbesserung der Rahmenbedingungen für Investitionen und Arbeitsplätze, Law to provide relief for families and to improve the climate for investment and jobs of 25 February 1992, BGBl I 1992 No. 9, S 324.

²³ See Bundesfinanzhof, resolution and rulings of 29 April 2009 I R 26/08, BFH/NV 2009, 1648; of 27 August 2008 I R 28/07, BFH/NV 2009/123; of 29 November 2000 I R 85/99, BStBl II 2002, 720; and already ruling of 30 May 1990 I R 97/88, BStBl II 1990, 875. In the more recent cases the Bundesfinanzhof has repeatedly made clear that its interpretation did not require change although the legislator defined the term 'business relationship' (new s. 4) in 1992; the tax authorities accepted this interpretation, see Federal Ministry of Finance, communication of 12 January 2010, BStBl I 2010, 34.

²⁴ Vgl. Bundesfinanzhof, ruling of 23 June 2010 IR 37/09, BStBl II 2010, 895.

²⁵ Gesetz zum Abbau von Steuervergünstigungen und Ausnahmeregelungen (Steuervergünstigungsabbaugesetz), Tax Preference Reduction Act of 16 May 2003, BGBl I 2003 No. 19, 666.

services. This applies also if the contractual agreement (for example the granting of a guarantee by a parent company for the benefit of a subsidiary) is taken up in the bylaws or has the character of substituting equity (due to the foreign company being undercapitalised). However, if the transaction (for example, the granting of a guarantee or a letter of comfort) has its basis in the shareholder relationship the transaction does not constitute a business relationship.

In 2008 the regulations concerning 'adjustment of income' were again revised and a new section (as section 3) was included. Section I(1) of the FTA currently reads as follows:

- (1) If the income of a taxpayer from a foreign business relationship with a related party has been reduced by basing its determination on terms, especially on pricing (transfer pricing), other than those on which mutually independent third parties would have agreed in similar or comparable circumstances (arm's length principle), it is to be adjusted, other provisions notwithstanding, to that which would have resulted from those terms as would have been agreed between mutually independent third parties. The arm's length principle is to be applied on the assumption that the mutually independent third parties had knowledge of all significant factors of the business relationship and were guided by the principles of orderly and conscientious business managers. Where the application of the arm's length principle leads to farther-reaching adjustments than under other provisions, the farther-reaching adjustments are to be made in addition to the consequences from those other provisions

In this version the 'adjustment of income' refers explicitly also to pricing (transfer pricing). It is also assumed that the contracting parties know of all significant factors of the business relationship and are acting in a 'prudent' manner. Finally, it is determined how this norm stands in relation to other adjustment norms and laid down that the various adjustments are to be applied in parallel manner.

The new section 3 regulates the order of priority of the admissible transfer pricing methods and prescribes how to apply price and margin ranges. It also brings the 'hypothetical arm's length comparison' into the canon of transfer pricing methods, supplements this method with subsequent adjustments and regulates how the hypothetical arm's length comparison is to be applied to business transactions forming a transfer of function. Finally, this section gives the government (and not the legislator) the power to regulate the details of applying the arm's length principle via decree law. These regulations will be subject to closer elaboration in the following section.

6.4 Main aspects of Germany's transfer pricing legislation

6.4.1 Corrective instruments

In order to prevent affiliated companies from shifting taxable profits or deductible expenses out of or into Germany by way of inappropriate transfer pricing arrangements of business conditions, the German tax legislator has created five basic defence mechanisms with respect to adjustment of income. The following instruments have to be taken into account in this context:

- general provisions on the attribution of assets and income and on the determination of tax base (sections 39 to 42 of the Fiscal Code (Abgabenordnung) (FC));
- hidden profit distribution (section 8(3) of the Corporate Tax Act (Körperschaftsteuergesetz), (CTA));
- hidden capital contribution (section 8(1) of the CTA in connection with section 4(1) sentences 3, 7 of the Income Tax Act (Einkommensteuergesetz) (ITA));
- deduction of interest costs for corporate entities (interest stripping rule) (section 8a of the CTA in connection with section 4h of the ITA); and
- adjustment of income in the case of business connections abroad (section 1 of the Foreign Tax Act (Außensteuergesetz) (FTA)).

The general provisions on the attribution of assets and income and on the determination of tax base apply to all areas of tax law and prohibit all manner of abusive arrangements. Of particular importance here is the fact that assets may not be attributed to the legal owner if someone other than the legal owner ('the economic owner') in fact exercises control over the asset in such a way that he can exclude the legal owner from having influence over the asset (section 39(1) of the FC).²⁶ It is also significant that it is irrelevant in the taxation context whether legal transactions are or become invalid. A comparable situation applies in connection with paper transactions. If a paper transaction is to cover up another transaction the latter is relevant for tax purposes (section 41 of the FC). But for practical purposes it is most relevant that tax laws may not be circumvented by using legal planning possibilities in abusive

²⁶ Examples of this are trust relationships, ownership reservation and particular leasing arrangements.

ways. Abuse is deemed to exist where an inappropriate legal planning option is chosen leading to a tax advantage for the taxpayer or a third party compared to the result of an appropriate arrangement, in a manner not intended by the law. In cases such as these the tax authorities are entitled to levy tax corresponding to that arising from business transactions with appropriate legal arrangements (section 42 of the FC). Shifting income to a controlled company can be abusive if the company has no economic substance because no offices exist and the company does not dispose of other necessary resources, for example. In the individual case, however, it needs to be examined whether particular tax laws contain special relevant provision. In this sense, with regard to the above example, the regulations concerning controlled foreign companies as set out in the Foreign Tax Act take precedence (section 7 *et seq.* of the FTA). Likewise, in respect to transfer prices or business conditions, the provisions of the particular tax laws take priority. In this context, the general legal instruments for adjusting income are 'hidden profit distributions' and 'hidden capital contributions'.

Profit distributions or dividend payments of all kinds cannot be deducted from taxable income. This also applies to 'hidden distributions' usually resulting from profit shifts between related parties. The Corporate Tax Act mentions, but does not define, the term 'hidden distribution'. According to the definition by the Federal Tax Court, a hidden distribution is 'a loss in net assets or prevention of an increase in net assets as a result of the corporate relationship which affects the level of income and is not the consequence of a resolution drawn up in accordance with company law for the distribution of profits'. It is to be added back to profit. A hidden distribution will be assumed wherever a company appears to have accepted business or financial disadvantages in favour of one or more of its shareholders or their related parties, unless an 'orderly and conscientious business manager' would also have done so within a third-party relationship under otherwise similar circumstances. Payment of excess prices for goods or services purchased by the company/subsidiary is an example. Another example of a hidden profit distribution is the charging of inappropriately low prices for goods and services rendered to the shareholder/parent company.

The corollary of a 'hidden distribution' of profits is the 'hidden contribution' of capital. Hidden contributions do not increase the profit of the recipient, but are also not deductible expenses for the (domestic) contributor. A hidden capital contribution must be a tangible benefit granted by a shareholder in that capacity (section 4(1) sentence 7 of the

ITA). If these grants increased the profit, they are to be deducted when the income of the company is determined. Whether or not this contribution is a result of the corporate relationship is gauged by reference to the same yardstick: Would an orderly and conscientious business manager have given the same benefit to a third party? Examples of such hidden contributions are supply of goods to a company/subsidiary at subnormal prices, and supply or rendering of goods and services to the shareholder/parent company at excessive prices. Intangible benefits, however, do not qualify as contributable assets.²⁷ The effect on profit of rendering services or loans at sub-par rates cannot, therefore, be adjusted with the help of the legal instrument of the hidden capital contribution.

Unlike the hidden profit distribution, the interest stripping rule places particular weight on combating profit shifting via group finance. Its aim is, in principle, the limitation of shareholder debt financing. The legal basis of the corresponding provision is to be found in corporate tax law and applies only to inbound cases. According to the interest stripping rule, which is also applicable for corporations (section 8a(1) of the CTA), net interest expenses paid by German taxpayers are only deductible for tax purposes up to 30 per cent of an entity's EBITDA (earnings before interests, taxes, depreciation and amortisation). In general, the interest expense can, however, be deducted without restriction, if:

- (a) the net interest expenses of the company are lower than 3 million euros in the relevant tax period (section 4h(2a) of the ITA); or
- (b) the company is not, or only in part, a member of a corporate group ('corporate group clause') (section 4h(2b) of the ITA); or
- (c) the company is a member of a corporate group and the company's equity ratio equals (with a 2 per cent tolerance) or exceeds the equity ratio of the controlled group as a whole ('escape clause') (section 4h(2c) of the ITA).

In order to prevent income shifting, the exception rules of this regulation are somewhat stronger for corporations than for individual taxpayers. The 'corporate group clause' applies only if the corporation's interest payment for shareholder debt does not exceed 10 per cent of the corporation's total net interest expense. Shareholder debt is assumed when the debt is granted (i) by a substantial shareholder (shareholding

²⁷ See, e.g., Bundesfinanzhof, Judgment of 24 May 1984 I R 166/78, BStBl II 1984, 747.

of more than 25 per cent); (ii) by a related party of the substantial shareholder; or (iii) by a third person who has rights of recourse over one of the persons mentioned above (section 8a(2) of the CTA). By the same token, the 'escape clause' applies only if the corporation's interest payment or the interest payment of another affiliated company for shareholder debt does not exceed 10 per cent of the corporation's total net interest expense. Interest payments are only relevant for this purpose if the corresponding loans are shown as liabilities in the fully consolidated accounts of the relevant corporate group (section 8a(3) of the CTA).

6.4.2 How German law defines the arm's length principle

Section 1 of the FTA deals with the 'adjustment of income'. This provision does not interfere with the other corrective instruments and gives them priority. This applies in particular in the case of hidden profit distributions and hidden capital contributions. Unlike the hidden profit distribution and hidden capital contribution, the 'adjustment of income' which transforms the arm's length principle of international double taxation treaties into German law, is limited to cross-border cases and business relationships with related parties. The currently valid version of the arm's length principle according to German law (section 1(1) of the FTA) has already been presented in the course of the section on historical background.

In order to guarantee uniform application of the law, executive authorities (in tax matters, the German Ministry of Finance) can with the approval with the Bundesrat (Federal Council) be empowered by law to set details of application for these legal provisions. In the area of transfer prices, the legislator has made use of this possibility in the determination of type, context and scope of the documentation required²⁸ and in connection with the cross-border transfer of functions.²⁹ Further reference will be made to this below. The tax administration has no other powers to issue legally binding regulations.

Irrespective of this, however, the authorities are able to issue administrative regulations in the interests of achieving equal application of the

²⁸ Ordinance regarding the Documentation of Profit Attributions of 13 November 2003, BGBl I 2003, 2296, most recently revised by art. 9 of the Company Tax Reform 2008 of 14 August 2007, BGBl I 2007, S 1912.

²⁹ Ordinance regarding the Transfer of Functions of 12 August 2008, BGBl I 2008, S 1680.

laws. Such administrative regulations consist of the Federal government's guidelines, the communications of the Ministry of Finance, the decrees of the State Finance Ministries, and the orders of the Higher Tax Offices. Although these are not legally binding for the individual taxpayer, they exert a *de facto* binding effect. They contain orders of an authority to a lower authority or an official within an authority, are binding on the officers of the tax authorities, and reflect the position of the tax administration with respect to individual cases or questions of doubt.

Among the most important administrative regulations in the area of transfer pricing, interpreting the legal provisions on the 'adjustment of income' (section 1(1) of the FTA) from the perspective of the tax authorities, are:

- Grundsätze zur Anwendung des Außensteuergesetzes,³⁰ Principles regarding the Application of the Foreign Tax Act;
- Grundsätze für die Prüfung der Einkunftsabgrenzung bei international verbundenen Unternehmen (Verwaltungsgrundsätze),³¹ Principles regarding the Audit of the Attribution of Income in Internationally Affiliated Companies ('Administrative Principles');
- Grundsätze für die Prüfung der Einkunftsabgrenzung durch Umlageverträge zwischen international verbundenen Unternehmen,³² Principles regarding the Audit of Profit Allocation using Cost Sharing Agreements by Internationally Affiliated Companies;
- Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen international verbundenen Unternehmen in Fällen der Arbeitnehmerentsendung (Verwaltungsgrundsätze – Arbeitnehmerentsendung),³³ Principles regarding the Audit of the Attribution of Income among

³⁰ Federal Ministry of Finance, Communication of 14 May 2004, IV B 4-S 1340-11/04, BStBl I 2004, 3 Special Issue 1; replaces Federal Ministry of Finance, Communication of 2 December 1994, VI C 7-S 1340-20/94, BStBl I 1995, Special Issue 1; replaces Federal Ministry of Finance, Communication of 11 July 1974, IV C 1-S 1340-32/74, BStBl I 1974, 442.

³¹ Federal Ministry of Finance, Communication of 23 February 1983, IV C 5-S 1341-4/83, BStBl I 1983, S 218; repealed in part by the Administrative Principles regarding Procedures, Federal Ministry of Finance, Communication of 12 April 2005, IV B 4-S 1341-1/05, BStBl I 2005, 570.

³² Federal Ministry of Finance, Communication of 30 December 1999, IV B 4-S 1341-14/99, BStBl I 1999, 1122.

³³ Federal Ministry of Finance, Communication of 9 November 2001, IV B 4-S 1341-20/01, BStBl I 2001, 796.

Internationally Affiliated Companies in Cases of the Posting of Workers ('Administrative Principles regarding the Posting of Workers').

Of central importance here are the Administrative Principles dating from 1983. This is underlined by the fact that today's version of the older principles regarding the application of the Foreign Tax Act contains no regulations of its own with respect to related persons, the corrective yardstick (arm's length principle), and the treatment of adjustments, but simply refers to the Administrative Principles. The principles regarding the application of the Foreign Tax Act only provide interpretations as to the form of adjustment and the term 'business relationship'.

The Administrative Principles give a detailed interpretation of the legal provisions regarding international attribution of income and include positions on various types of inter-company transactions. Originally, these principles provided guidelines on cost sharing arrangements, adjustment methods and related procedural aspects. In the course of revising and adjusting these principles in line with developments at the level of the OECD, the Federal Ministry of Finance issued regulations governing these areas in a separate communication. The communication regarding cost sharing arrangements deals with details concerning application of the arm's length principle as far as they affect general prerequisites for application, the allocable amount, the allocation mechanism, special cases, documentation and provision of evidence. The Administrative Principles regarding the Posting of Workers regulate in particular the attribution of expenses associated with the posting of staff, relevant qualification criteria, special arrangements, questions of treatment for tax purposes, and the procedure and duties concerning provision of evidence and cooperation.

In the aftermath of a Federal Tax Court case in 2001 which will be discussed in the following section, section 1 of the FTA has been supplemented with documentation and penalty provisions. These are:

- documentation requirements for cross-border transactions with related parties including permanent establishments (section 90(3) of the Fiscal Code);
- consequences of inadequate or missing documentation, including in particular the rebuttable assumption of a need for profit adjustments and the allowance to estimate income by use of least favourable point in a price range (section 162(4) of the FC); and

- penalties (5 to 10 per cent of profit adjustment with certain ceilings and restrictions) in the case that the taxpayer is non-compliant with documentation requirements (section 162(4) of the FC).

Additional detail to the latter provisions were laid down in a legal ordinance and explained in the context of administrative principles (binding for subordinate authorities). These provisions and regulations comprise:

- Verordnung zu Art, Inhalt und Umfang von Aufzeichnungen im Sinne des § 90 Abs. 3 der Abgabenordnung (Gewinnabgrenzungsaufzeichnungsverordnung – GAufzV), Ordinance regarding the type, content and scope of records in the meaning of section 90(3) of the FC (Ordinance regarding the Documentation of Profit Attributions);³⁴ and
- Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen nahe stehenden Personen mit grenzüberschreitenden Geschäftsbeziehungen in Bezug auf Ermittlungs- und Mitwirkungspflichten, Berichtigungen sowie auf Verständigungs- und EU-Schiedsverfahren (Verwaltungsgrundsätze-Verfahren),³⁵ Principles for the audit of the attribution of income between related parties with cross-border business relationships with reference to the obligation to determine transfer prices and to cooperate with the tax administration, adjustments as well as their implications in terms of competent authority and EU arbitration procedures (Administrative Principles regarding Procedures).

The ordinance governs the type, content and scope of records in the case of ordinary, specific and exceptional business transactions. Besides a duty to document the facts and circumstances on which the transactions between related parties are based, the ordinance explicitly demands also evidence on the appropriateness of transfer prices applied (grounds for the suitability of the transfer pricing methods used, calculations and comparable data). In addition, the administrative principles regarding procedure reflect the position of the tax authorities regarding questions dealing with duties of the tax authorities, participants' duties to cooperate, legal consequences of failure to cooperate, implementation of

³⁴ Ordinance regarding the Documentation of Profit Attributions of 13 November 2003, BGBl I 2003, 2296, most recently amended by art. 9 of the 2008 Company Tax Reform Act of 14 August 2007, BGBl I 2007, 1912.

³⁵ Federal Ministry of Finance, Communication of 12 April 2005, IV B 4-S 1341-1/05, BStBl I 2005, 570.

adjustments and process of transfer price corrections and mutual agreement or arbitration procedures. The details of this communication, which runs to more than 70 pages in length, cannot be given here. But for practical purposes the statements it includes on choice of method and application of database analyses and benchmarking studies are of particular relevance.

Under the 2008 Company Tax Reform Act, section 1 of the FTA obtained a new subsection determining the order and the prerequisites for applying the internationally accepted transfer pricing methods in accordance with German law. Moreover, the 'hypothetical arm's length comparison' was specified in more detail, as were its application in cases of the transfer of functions, and the possibilities of retrospective price adjustments.

The focus of the changes to the arm's length principle in German tax law (section 1 of the FTA) is on the determination of a hierarchy and the terms of application for individual transfer-pricing methods. Consequently, for intra-group cross-border business transactions, the German Foreign Tax Act requires the transfer price to be determined primarily according to the comparable uncontrolled price method, the resale price method or the cost plus method. The condition for this is that arm's length values can be found that, after adjustment as appropriate in view of the functions performed, the assets employed and the opportunities and risks assumed are comparable without limitation to those methods; several such values form a range. If no such arm's length values can be found, the application of a suitable transfer pricing method is to be based on values of limited comparability as appropriately adjusted. If no third party values of at least limited comparability can be found, the taxpayer is to base his income determination on a hypothetical third-party comparison. For this, he is to estimate the lowest price for the seller and the highest price for the buyer on the basis of a functional analysis and internal planning calculations. This scope for agreement is to follow from the profit expectations (profit potential) of each party. The price to be taken is that most likely to accord with the arm's length principle. If no other value is plausibly put forward, the mean of the scope for agreement is to be taken.

Where a function including the related opportunities and risks is transferred, accompanied by assets and other advantages transferred or lent for which no arm's length value of even limited comparability can be found, the taxpayer shall determine the scope for agreement on the

basis of the transfer of the function as a whole (transfer package). This has to be done on the basis of capitalisation at adequate interest rates. The piece-meal determination of the transfer prices for all assets and services transferred, as appropriately adjusted, is to be accepted if the taxpayer can show convincingly either that no important intangibles or advantages, or the use thereof, were transferred with the function or that the sum of the piece-meal prices is equivalent to the arm's length price for the transfer package as a whole.

Where significant intangibles and advantages derive from a business connection and the future profitability varies significantly from the assumption on which the transfer price was based, there is to be a refutable presumption that, at the time of the contract, there was uncertainty as to future profits, and independent third parties would have agreed on a suitable price adjustment provision. If no such provision was agreed and there is a significant variance during the first ten years from the date of the contract, the adjustment is to be made in an appropriate lump sum amount as a correction to the original transfer price with tax effect for the business year following that in which the variance occurred.

Like the documentation provisions, this addition to the application of the arm's length principle in Germany has also been supplemented by a legal ordinance dealing with the taxation of transfer of functions, and has been explained in corresponding administrative principles. These are:

- Verordnung zur Anwendung des Fremdvergleichsgrundsatzes nach § 1 Abs. 1 des Außensteuergesetzes in Fällen grenzüberschreitender Funktionsverlagerungen (Funktionsverlagerungsverordnung – FVerlV), Ordinance on the application of the arm's length principle pursuant to section 1(1) of the FTA in cases of cross-border transfer of functions (Ordinance regarding the Transfer of Functions);³⁶
- Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen nahe stehenden Personen in Fällen von grenzüberschreitenden Funktionsverlagerungen (Verwaltungsgrundsätze Funktionsverlagerung),³⁷ Administrative Principles regarding the Transfer of Functions.

At the core of this ordinance and these administrative principles are the new terms 'function', 'transfer of function' and 'transfer

³⁶ Ordinance regarding the Transfer of Functions of 12 August 2008, BGBl I 2008, 1680.

³⁷ Federal Ministry of Finance, Communication of 13 October 2010, IV B 5-S 1341/08/10003, BStBl I 2010, 774.

package', which are discussed in the international arena under the headings of 'business reorganisation', 'transfer of an activity' and 'transfer of something of value'. In the context of the German regulations, the spotlight is on provisions regarding the determination of the value associated with the assets and other advantages bundled in a 'transfer package' (assets and other advantages such as goodwill forming an integrated part of a business), and on the conclusion resulting for the determination of respective transfer prices. Setting arm's length prices for intangible assets and transfer packages will be discussed in greater detail in the next section as these currently have no OECD parallels.

Ultimately, in 2011 the Ministry of Finance issued a decree regarding bad debt losses on a receivable from a foreign related party. This is:

- Anwendung des § 1 AStG auf Fälle von Teilwertabschreibungen und andere Wertminderungen auf Darlehen an verbundene ausländische Unternehmen,³⁸ Application of section 1 of the FTA to write-downs to going concern value and to other impairments regarding loans to foreign related companies.

The Ministry made it clear that a bad debt loss on a receivable from a foreign related party is only allowable where the taxpayer can show that a third party would not have taken steps beforehand to recover or secure the outstanding sum. It suggests that this could be the case where it was clearly in the business interests of the lender not to pursue debt recovery vigorously in order to maintain trading relationships. However, it offers no other examples of an acceptable write-down. The Ministry's reasoning is based on the arm's length requirement of the Foreign Tax Act which includes adequate security for a related party debt. Adequate security can, however, be seen in overall group support to enable a subsidiary to meet its debts as they fall due. Accordingly, no charge can be made for enhanced risk of default within a group. On the other hand, a default itself demonstrates the failure of that support. Hence the debt would have arisen, or been allowed to remain, in other than arm's length circumstances. Its write-off is therefore per se disallowable.

³⁸ Federal Ministry of Finance, Communication of 29 March 2011, IV B 5-S 1341/09/10004, BStBl I 2011, 277.

6.4.3 *Determining the arm's length price for intangible assets and transfer packages according to the concepts of the hypothetical arm's length method*

Steps

In order to determine the values of the relevant profit potentials, it is necessary to:

- (i) identify the anticipated future benefits associated with the transferred asset or transfer package;
- (ii) determine the useful lives of the corresponding assets; and
- (iii) establish the required rate of return for purposes of calculating the net present value of the profit potential associated with the assets or transfer packages transferred.

The minimum and maximum prices are further determined by action alternatives as well as the transaction costs including, but not limited to, taxes on capital gains arising in the course of the transfer or sale of assets or other benefits (e.g., goodwill).

(i) *Determination of anticipated future benefits*

According to the guidelines provided by the German tax authorities, the relevant income for determining the net present value of anticipated future benefits refers to the financial surpluses net of expenses, interest on debt capital and taxes flowing to the enterprise over the useful life of the asset or transfer package transferred. Typically, these cash flows are derived from planned results.

As taxes on income typically reduce to varying extent the cash flows attributable to the asset or transfer package and the cash flows of an investment alternative (represented by the cost of capital), corporate taxes have to be taken into account as expenses on the level of the corporate entity. Relevant amounts are those taxes that will presumably be assessed or have actually been assessed, paid and, as the case may be, already reduced by a given tax relief. Different views exist on whether or not to take personal taxes on corporate dividends into account.

From the perspective of the acquiring enterprise, it is to be noted that the acquisition of (a bundle of) assets is associated with tax amortisation benefits. The need to take this benefit on board results from the fact that the corporate tax to be paid is calculated on the basis of cash flows (whereas the tax base is corporate income). If looking at (parts of) an enterprise as a whole, it is not uncommon to factor in the corresponding

tax benefits on a global basis. This global procedure, however, is not without difficulties as it does not allow for an appropriate allocation of the purchase price to the individual assets transferred. Instead, it would be more consistent to differentiate between the assets involved in the transfer when adding the tax amortisation benefit to the net present value of the anticipated cash flows.

(ii) *Determination of the discount period/useful lives*

Regarding transfer of activities, the German administrative guidelines require us to act on the assumption that the useful lives of the assets involved are not limited (i.e., to calculate the net present value based on an infinite capitalisation period) when determining the profit potential of an enterprise as a whole. This does not hold if reasons speaking in favour of a shorter capitalisation period exist or can credibly be shown.

(iii) *Determination of the required rate of return*

In order to determine the required rate of return, the customary interest rate regarding a quasi-riskless investment serves as a point of departure. More precisely, the calculation is to be based on riskless investments, the duration of which is equivalent to the expected term of the activity or the useful lives of significant intangible assets. Where capitalisation is to be based on an unlimited period of time, the rate of return regarding a comparable investment of a term as long as possible should be decisive.

The basic interest rate is to be increased by a premium reflecting the risk of the underlying investment. Where the subjects of valuation are activities, such premiums are to be determined by looking at the customary market return which may be earned when carrying out comparable activities.

Determination of the arm's length price

The scope for agreement is determined by minimum and maximum prices that the seller and acquirer wish to achieve or are prepared to pay. Such a scope for agreement results if the minimum price of the seller falls below the maximum price of the acquirer. In determining the minimum price, the seller looks at the profit potential associated with the asset(s) and other benefits transferred. Moreover, the expected costs arising as a consequence of the transfer (e.g., costs associated with closing down an enterprise or terminating an activity but also possible taxes on capital gains relating to the asset transfer) factor into this calculation. In this

context, options realistically available to the seller (e.g., outsourcing a production activity by way of contract manufacturing) are to be taken into account.

When determining the maximum price, the acquiring company looks at the profit potential that it expects to realise through making use of the asset to be transferred or the activity to be carried out. In this context, options realistically available to the acquiring company are to be taken into account, assuming that the acquiring company is independent from the seller and is able to make use of complete information.

Regarding the scope for agreement, the price to be taken is that most likely to accord with the arm's length principle. If no other value is plausibly put forward, the mean of the scope for agreement is to be taken. This 'mean solution' is based on the assumption that (1) the benefit accruing to the contracting parties corresponds to the difference between the mean value and their minimum or maximum price and (2) the allocation of related benefits for the parties is fair if these benefits are of equal weight. Among third parties, moreover, bargaining skills, bargaining power, haste and other impacting factors may play a role.

According to the German administrative principles, a 'significant determination' justifying a later price adjustment is given if a retrospective calculation based on the actual development of profits shows that the true transfer price is outside the original scope for agreement. In reconsidering this true transfer price, however, it is only correct to take those developments into account for which uncertainty existed at the time of the transfer, thus leading to some flawed assessment regarding later developments. On the other hand, those changes in future developments resulting from post-transaction activities (later investments or reorganisation measures) should not be taken into account when retrospectively calculating the 'true' transfer price.

6.5 Transfer pricing disputes: domestic approaches

6.5.1 Final meeting in tax audits

In the interests of an equitable determination and assessment of tax relevant facts and circumstances, tax authorities in Germany can order tax audits to be carried out. The tax authorities decide with due discretion whether and, if so, when a tax audit is to be conducted. Taxable parties subject to tax audits are put into categories in terms of size which distinguish between large businesses, medium-sized businesses, small

Table 6.5 *Taxable parties subject to tax audits in Germany over the period 2007 to 2010*

| Numbers of businesses | 2007 | 2008 | 2009 | 2010 |
|-------------------------|-----------|-----------|-----------|-----------|
| Large businesses | 170,060 | 170,060 | 170,060 | 191,638 |
| Medium-sized businesses | 758,051 | 758,051 | 758,051 | 799,135 |
| Small businesses | 1,141,147 | 1,141,147 | 1,141,147 | 1,189,727 |
| Very small businesses | 6,321,466 | 6,321,466 | 6,321,466 | 6,391,015 |

Table 6.6 *Additional revenue and interest as a result of tax audits in Germany over the period 2007 to 2010**

| Additional revenue and interest | 2007 | 2008 | 2009 | 2010 |
|---------------------------------|--------|--------|--------|--------|
| Large businesses | 13,196 | 13,974 | 15,292 | 11,916 |
| Medium-sized businesses | 1,387 | 1,330 | 1,253 | 1,349 |
| Small businesses | 626 | 666 | 690 | 679 |
| Very small businesses | 817 | 1,018 | 1,058 | 972 |

* Indications in billion euros

businesses and very small businesses. The determination of the number of businesses and classification into size categories takes place, as a rule, every three years. As of 1 January 2010 the figures shown in Table 6.5 resulted.

In 2010, audits of trading or business enterprises, the businesses of self-employed persons, agricultural or forestry businesses of all sizes and associations of builder-owners, loss-allocating companies and other taxable parties have led to additional tax and interest amounting to approximately 16.8 billion euros. Broken down according to the various size categories the results are as shown in Table 6.6.

Even though the greater part of additional tax (2010: 71.1 per cent) arises from audit of the large businesses, for reasons of equitability these audits cannot be limited to this category. For the years 2007 to 2010 the number of audits and audit cycles within the size categories were as shown in Table 6.7.

As a general rule no special audits are carried out for transfer prices. Instead, transfer price auditing is carried out in the framework of the regular tax audit which normally covers a period of three to five years. However, the tax audit of interest has, over recent years, increasingly been focused on the area of transfer pricing, with relevant training of the

Table 6.7 Number of audits and audit cycles in Germany over the period 2007 to 2010 within the categories in terms of size

| Number of tax audits and audit cycles | 2007 | 2008 | 2009 | 2010 |
|---------------------------------------|---------|---------|---------|---------|
| Large businesses | 38,662 | 39,885 | 38,988 | 40,502 |
| Audit cycle | 4.4 | 4.3 | 4.4 | 4.7 |
| Medium-sized businesses | 59,068 | 56,999 | 55,157 | 55,315 |
| Audit cycle | 12.8 | 13.3 | 13.7 | 14.5 |
| Small and very small businesses | 115,645 | 113,752 | 112,379 | 108,086 |

Table 6.8 Numbers of tax auditors in Germany over the period 2007 to 2010

| | 2007 | 2008 | 2009 | 2010 |
|-------------------------|--------|--------|--------|--------|
| Numbers of tax auditors | 13,646 | 13,337 | 13,332 | 13,210 |

auditors and the involvement of specialists from the Federal Central Tax Office and the Regional Tax Offices. For the purposes of conducting tax audits, more than 13,000 auditors were employed over recent years (see Table 6.8).

Furthermore, 173 auditors from the Federal Central Tax Office took part in a total of 601 tax audits supported by Regional Tax Offices and completed in 2010.

Experience shows that personal exchange between the authorities and the taxpayers has dispute-arbitrating effect. This is why a meeting concerning the result of the tax audit is to be held at the end of the process (final meeting), unless, as a result of the tax audit, there is no change to the tax base, or if the taxpayer decides to forego such a meeting. In the course of a final meeting, as well as disputed matters, the legal assessment of the results of the audit and its tax consequences will be discussed (section 201 of the FC). Although this event is sometimes described as a kind of 'oriental bazaar', in many cases the final meeting results in the tax authority and the taxpayer reaching consensus on the tax treatment. This is particularly true in the area of transfer pricing. In cases where the taxpayer and the tax authorities cannot agree on a common view in the course of the tax audit, the taxpayer is entitled to take legal recourse with respect to the tax assessment.

6.5.2 Appeals procedure

In Germany, administrative courts have the task of protecting subjects in the case of official action. In tax matters, the tax courts are called upon to judge as specialised administrative courts. In order to prevent tax courts being flooded with law suits, the court procedure is proceeded by an administrative appeals procedure which gives the tax authority the opportunity to scrutinise the cases once again ('preliminary procedure'). Unlike the courts the tax authorities are bound by administrative regulations (guidelines, communications, orders and decrees).

In tax matters, the administrative appeals procedure is termed *Einspruch* (objection). If such an objection is admissible,³⁹ the tax authorities are required not only to reassess the initial decision in its entire scope, but also to clarify the facts and circumstances of the case. Upon application or (in certain circumstances) *ex officio*, the authorities are required to open the tax documentation and may (*ex officio*) or should (upon application by the applicant) discuss the facts and legal status of the case prior to making the appeal decision (hearing). This regulation serves, on the one hand, to realise the principle of '*rechtlisches Gehör*' (legal hearing) (section 91(1) of the FC) and, on the other hand, has the further aim of promoting mutual solution of the appeal, thereby reducing the number of disputes to be dealt with in court.⁴⁰

Should the objection be found to be (partly) justified, the tax authorities can take remedial action by (partly) withdrawing, amending or waiving the contested administrative act (section 367 of the FC). A formal decision is only needed if the tax authorities provide no remedy to the appeal. If, from the perspective of the tax authorities, the appeal is unjustified or inadmissible, it is rejected as being unfounded (section 366 of the FC) or is formally declared to be inadmissible (section 358 of the FC).

If the out-of-court legal remedy fails to bring success, in disputes concerning tax matters the taxpayer can take recourse to the fiscal

³⁹ The preconditions for this are that the objection is available by law in the case at hand, the taxpayer is permitted to make an objection because he is burdened by an administrative act as a result of a breach of the law, a flawed application of the law or inappropriate exercising of discretion, that he has legal and tax capacity, that he has observed the prescribed form and period of objection, that he is in need of legal protection and the objection has not been withdrawn.

⁴⁰ So explicitly Deutscher Bundestag, printed matter 12/6959, on s. 364a of the FC, 131, printed matter 12/7427, on s. 264a of the FC, 37.

court.⁴¹ The tax jurisdiction is an independent arm of the national jurisdiction exercised through specific administrative courts. Unlike the general administrative jurisdiction, it is structured on two levels. The tax courts decide in a first legal action as an interlocutory hearing (section 35 of the Finanzgerichtsordnung (Code of Procedure of Fiscal Courts, CPFC) whereas the Federal Tax Court deals explicitly with court of appeals proceedings for appeals and complaints against initial decisions of the tax courts (section 36 of the CPFC). But review of the facts and circumstances by the tax courts requires the fulfilment of admissibility conditions. In addition to the formal preconditions (admissibility of recourse to the tax courts, courts jurisdiction, proper commencement of the action, observation of compliance with the time period), they include the right of action, the legal capacity as an involved party and legal capacity to act, and in particular also a legitimate interest to take legal action.

In tax court proceedings, the tax court is required *ex officio* to investigate the facts and circumstances ('investigative principle'). Court rulings result in principle from an oral hearing. Irrespective of this, all persons have a right to be legally heard (article 103(1) of the Basic Law). This right includes in particular the fact that a judgment can only be based on facts and evidence concerning which the participating parties were able to express themselves ('right of expression'). With regard to the standard of evidence, the Code of Procedure of Fiscal Courts favours a cooperative division of responsibility between the participating parties. A possible breach of legal procedural duties (duties relating to recording, to storage, presentation and cooperation) has to be taken into account. According to this distribution, a taxpayer may not gain advantage as a result of violating his duties to cooperate. In this sense the law is geared to the participants' sphere of responsibility. If the deficit in clarification stems from insufficient or lacking cooperation on the part of the taxpayer, the standard of evidence in the case of facts giving rise to or raising tax is lowered. Here, the tax authority is required to carry the objective burden of proof. But the standard of evidence remains high if tax-relieving or tax-diminishing facts are not clarified due to lack of cooperation (section 162 of the FC). For facts relieving or limiting the authorities' claim to tax, the burden of proof lies with the taxpayer.

⁴¹ Unlike actions for rescission or actions requesting a change of a legal right or status, aiming at the annulment or amendment of an administrative decision, general actions for injunction or actions for a declaratory judgment need no preliminary procedure (s. 40 of the Finanzgerichtsordnung, Code of Procedure of Fiscal Courts).

Legal remedies are the revision appeal and complaint to the Federal Tax Court. Revision appeals are directed against judgments whereas complaints can be made in the context of all other decisions or resolutions of the tax court. Revision appeals have to be admitted as a general principle. The tax court or, in the event of a complaint being laid before the Federal Tax Court in respect to the denial of admissibility, the Federal Tax Court may only admit a revision appeal if:

- (a) the legal matter is of significance in principle (revision appeal on a matter of principle);
- (b) the further development of law requires a decision by the Federal Tax Court (revision appeal on a matter of further development of law);
- (c) ensuring uniform rulings makes a decision by the Federal Tax Court necessary (revision appeal for uniformity of rulings); or
- (d) a procedural flaw exists upon which the decision could have formed the basis of the ruling (revision appeal on procedural matters).

The revision appeal is decided by the Federal Tax Court. If there are deemed to be grounds for the revision appeal, the court has to reach decision itself. The precondition for this is that the legal matter is ready for decision. Otherwise the decision of the (lower) tax court is to be cancelled and the legal matter is to be referred back to the tax court for hearing, negotiation and decision. This referral back is necessary in particular where further determination of facts has to be carried out since the Federal Tax Court is not an interlocutory instance (no new facts and evidence may be presented to the Federal Tax Court which is bound by the findings of the lower tax court).

If the basic rights of a taxpayer who has exhausted the possibilities of legal recourse to the specific courts are violated, an appeal before the Federal Constitutional Court is admissible. In a similar way, the legal matter may be referred to the European Court of Justice if there is a question of European law being violated.

6.5.3 Important court rulings with respect to transfer pricing

Overview

As presented when discussing the corrective instruments, in Germany five basic defence mechanisms with respect to the adjustment of income exist. In this context, the general legal instruments for adjusting income are 'hidden profit distributions' and 'hidden capital contributions', section 1 of the FTA ('adjustment of income') does not interfere with these

corrective instruments and gives them priority. As a consequence, it comes as no surprise that in the area of profit attribution, by far the greatest number of rulings handed down by the Federal Tax Court dealt with questions regarding 'hidden profit distribution'. In relation to a controlling business manager, hidden profit distributions already emerge if the underlying transaction lacks a clear and seriously agreed, written agreement set up in advance.⁴² As a consequence, the courts typically verify whether transactions between affiliated parties are based on upfront (written) agreements and result in an income allocation comparable to that arising from transactions between third parties. In comparison to 'hidden profit distributions', court rulings on 'hidden capital contributions' are less numerous. But court rulings on the adjustments of income according to section 1 of the FTA show the lowest level of distribution.

Concerning the attribution of profits to affiliated companies, the rulings of the Federal Tax Court relating to:

- the transfer of a market and a customer base;
- the interpretation of the legal term 'business relationship';
- the interest rate to be applied;
- permanent loss situations;
- licensing a trade and a company name;
- cooperative duties; and
- transfer prices concerning goods

are of particular importance for the determination of transfer prices in Germany.

⁴² See, e.g., Bundesfinanzhof, Judgment of 6 December 1995 I R 88/94, BStBl II 1996, 383 (with reference to payment of management remuneration), Judgment of 17 May 1995 I R 147/93, BStBl II 1996, 204 (with reference to the terms of a pension agreement). The arm's length principle does not address formal criteria. Where an exchange of goods or services has taken place, the only question to deal with in the framework of the arm's length principle is the remuneration as usual in third party transactions. According to the wording of the arm's length principle it is not of significance whether the terms of the transaction were influenced by a related party. This was made clear in Germany by the Cologne Tax Court which had to rule concerning the relationship between the hidden profit distributions and the arm's length principle as set out in Article 9 of double taxation treaties. The Tax Court of Cologne takes the view that the double taxation treaty as provided in Article 9 of the OECD Model Agreement develops a blocking effect against hidden profit distributions in cases in which according to domestic law the profit adjustment is based on purely formal criteria, cf. Tax Court of Cologne of 22 August 2007, *Deutsches Steuerrecht, Entscheidungsdienst* (journal) 2008, 696; of different opinion Administrative Principles, Federal Ministry of Finance, Communication of 12 April 2005, BStBl 2005 I, p. 570, No. 6.1.1.

(i) Transfer of a market and a customer base

The court ruling I R 152/82 concerned the transfer of an 'export market' free of charge by a lower-tier subsidiary to a higher-tier subsidiary.⁴³ As this 'export market' failed to fulfil the criteria of a 'Teilbetrieb' (operating unit) the local tax office came to the conclusion that the transfer of this 'market' did not constitute a transfer of goodwill. However, the tax office assessed this as a hidden distribution (transfer) of an asset comparable to goodwill, 'market and customer base'. The Federal Tax Court made it clear that the lower tax court had not given due consideration to the fact that according to the taxpayer the customers of the lower-tier subsidiary consisted only of two group companies. If a hidden profit distribution was to be assumed, the higher-tier subsidiary would have had to have been in receipt of an asset value which it had not previously held. On the other hand, the Federal Tax Court found that the lower-tier subsidiary could have granted an advantage to the higher-tier subsidiary in that it agreed to cancel immediately an existing contractual relationship without demanding any compensation. Since this called for further clarification of the facts, the revision appeal led to the cancellation of the ruling of the lower tax court and the referral back to the lower tax court.

In contrast to the decision I R 152/82, the decision I R 150/82 of the same date dealt with the transfer of an operating unit between sister companies without compensation for the goodwill actually concerned.⁴⁴ The Federal Tax Court saw this process as constituting a hidden distribution of the goodwill to the common parent company and its subsequent contribution to the sister company receiving the advantage. In more recent decisions, the Federal Tax Court no longer maintained the idea that for tax purposes the transfer of goodwill could only be carried out in the context of an operation or an operating unit.⁴⁵

⁴³ Bundesfinanzhof, Judgment of 20 August 1986 I R 152/82, *Bundesfinanzhof Rulings/not to be published* (journal) 1987, 471.

⁴⁴ Bundesfinanzhof, Judgment of 20 August 1986 I R 150/82, BStBl II 1987, 455.

⁴⁵ Cf. Bundesfinanzhof, Judgment of 16 June 2004 X R 34/03, *Bundesfinanzhof Rulings/not to be published* (journal) 2004, 1701; Judgment of 27 March 2001 I R 42/00, BStBl II 2001, 771.

(ii) Interpretation of 'Geschäftsbeziehung' (business relationship) as a legal term

The interpretation of the term 'business relationship' by the Federal Tax Court (I R 97/88, I R 94/88, I R 85/99, I R 5-6/02, I R 28/07, I R 26/08)⁴⁶ has been discussed above in the course of describing the historical development of section 1 of the FTA.⁴⁷ The term 'business relationship' now covers 'any contractual relationship affecting income, other than an agreement between a company and its shareholders'.

(iii) Interest rate to be applied

Judgment I R 93/93 concerned a loan agreement between German shareholders and a Canadian corporation.⁴⁸ The local tax office found the agreed interest rate to be inappropriately low and adjusted the profit of the German shareholders on the basis of section 1 of the FTA. For the purposes of this adjustment the local tax office took as its orientation the average interest rates payable in the year of dispute for current account overdrafts, taking as a basis an interest rate of 14 per cent. The Federal Tax Court ruled that in the case of loans of private individuals, the decisive interest rate is in the first place the bank borrowing rate. When taking the usual borrowing rate as a basis, it has to be borne in mind, they found, that the loan was granted by private persons. It was to be taken into account with interest-raising effect if insufficient collateral was available for the loan. In the case that such circumstances justify no other result, the tax court can, according to the Federal Tax Court, take it as a guiding basis that the loan granter and the loan recipient will in case of doubt share equally the range between the usual bank lending rate and borrowing rate.

A similar result was already achieved in the Federal Tax Court's decision I R 83/87.⁴⁹ The court ruled that the interest rate being appropriate for the individual case is to be determined by estimate within the range between the usual bank lending rate and borrowing rate, giving

⁴⁶ Bundesfinanzhof, Judgment of 30 May 1990 I R 97/88, BStBl II 1990, 875; Judgment of 5 December 1990 I R 94/88, BStBl II 1991, 287; Judgment of 29 November 2000 I R 85/99, BStBl II 2002, 720; Judgment of 28 April 2004 I R 5-6/02, BStBl II 2005, 516; Judgment of 27 August 2008 I R 28/07, *Bundesfinanzhof Rulings/not to be published* (journal) 2009, 123.

⁴⁷ See section 6.3 above.

⁴⁸ Bundesfinanzhof, Judgment of 19 January 1994 I R 93/93, BStBl II 1994, 725.

⁴⁹ Bundesfinanzhof, Judgment of 28 February 1990 I R 83/87, BStBl II 1990, 649.

particular weight to the risk that the loan may not be repaid. The court believes that, as a general rule, employing the bank lending rate is not justified, in particular if the company in question is not operating a bank business and, therefore, is not burdened with the corresponding expenses. Where no other evidence is perceptible, the arm's length principle does not preclude an assessment being based on the empirical judgement that private loan granter and loan recipients share equally the range between the usual bank lending rate and borrowing rate.

(iv) Long-term losses

The decision I R 3/92 concerned a German distributor company suffering from long-term losses resulting from the distribution of branded goods of its Danish parent company.⁵⁰ The tax auditors objected to the fact that since the launch of these products in Germany the Danish parent company did not participate in the considerable expenses that arose at the level of the German company from advertising and introducing the products on the German market. As the auditors expected the parent company to compensate its subsidiary for these expenses, they treated the corresponding 'waiver' as hidden profit distribution. The Tax Court decided in favour of the taxpayer and permitted revision appeal to the Federal Tax Court. This latter court set the decision of the tax court aside and, for purposes of further determination of the facts and circumstances, referred the legal matter back to the tax court. The Federal Tax Court found that an orderly and diligent business manager of a distributor company would introduce and sell products in the market if, based on a careful forecast, he can expect an appropriate total profit. In this context, it was to be assumed that in the start-up phase the loss period does not exceed a horizon of three years. But the conclusion reached by the tax court went no further than the assumption that in the context of a long-term market strategy, the distributor company achieves an appropriate profit. It did not, however, state in concrete terms that in a long-term market strategy the company will accrue an appropriate profit without participation of the producer in the advertising and introductory costs. As the Federal Tax Court could not itself scrutinise the considerations of the tax court, it deemed it necessary for the facts and circumstances to be further clarified by the latter court.

⁵⁰ Bundesfinanzhof, Judgment of 17 February 1993 I R 3/92, BStBl II 1993, 457.

The case I R 92/00 dealt with the treatment of expenses in connection with the activities of a company suffering from long-term losses.⁵¹ The Federal Tax Court stated that it cannot be decisive whether the activity had promised to be successful when viewed in retrospect. It was further to be taken into account that the profit outlook for a new business activity can only be assessed after a start-up phase has occurred, and that losses cannot constitute grounds for assuming that there is no intention of achieving profit, provided that the company reacts by taking suitable measures. This would only be otherwise if it can be concluded that no viable business plan exists, or that the activity serves, from the outset, private interests or the interests of the shareholder.

Losses also constitute the issue in question in the legal matter I R 22/04.⁵² The case concerned a distributor company which, after a price rise, achieved only below-average yield from marketing the products of its Swiss sister group company, and in the year of dispute even had negative income. Following on from the judgment I R 3/92, the Federal Tax Court ruled that a distributor company will not normally accept purchase prices which will only allow the products concerned to be sold at a loss. The taxpayer was able to show that the intra-group pricing was based on a price list applying equally in relation to other buyers from the foreign sister company. But according to the decision of the Federal Tax Court the employment of this 'comparable uncontrolled price method' requires that the price under consideration and the comparable price must be derived from at least essentially similar exchange of goods or services. This is not the case if on the basis of the prices stated, the distributor company has no possibility of making an appropriate distributing profit (disregarding short-term, temporary 'lean periods'). No fixed rules apply, but it is one of the acknowledged principles that the cost price paid by a distributor company can be checked with the help of the resale price method. In this context, where companies distribute both products of an associated company and comparable goods from other manufacturers, looking at the margins earned on products from other manufacturers can supply important reference information.

⁵¹ Bundesfinanzhof, Judgment of 15 May 2001 I R 92/00, *Bundesfinanzhof Rulings* (journal) 199, 217.

⁵² Bundesfinanzhof, Judgment of 6 April 2005 I R 22/04, BStBl II 2007, 658; see also Judgment of 17 October 2001 I R 103/00, BStBl II 2004, 171.

In the decision I R 103/00,⁵³ the Federal Tax Court ruled that substantial losses over a three-year period elicit a refutable presumption that the agreed transfer price is inappropriate and motivated by the company relationship. This applies in particular if the trading of group-internally manufactured products constitutes more or less the entire business activity of the distributor company. In the context of its onus to present evidence, the taxpayer can demonstrate why the development is in fact due to other reasons. If the presentation of such evidence is successful, losses can be allowed even beyond the period of three years, provided that the taxpayer implements any adjustment measures that may be necessary.

(v) Passing on right of use of a group and brand name

The decision I R 12/99 concerned payment for the right of a group-affiliated company to use the group name and logo.⁵⁴ The tax authorities treated the licence charge paid as a hidden profit distribution. The tax court dismissed the action brought against this decision since it recognised no deductibility of payments within the group constellation. The Federal Tax Court overruled this decision and referred the case back to the tax court for further clarification of the facts. In its decision, the Federal Tax Court was following a point of differentiation discussed in German specialist literature which resulted in the view that rights to use of names and company names, on the one hand, are to be distinguished from brand names and trademark rights, on the other. Trademark rights as product-identifying designations are to be distinguished from company names. This is necessary even when brand and company names are identical; the right to use of the name must then be subordinate at least to a certain extent to the right of trademark. It is thus decisive whether the payment is made for granting entitlement to use of the company name or for the brand name. The right of use to brand names stands in the foreground if the rights connected with the granting of the brand are suited to promoting sales. If the licence recipient is able to improve his own position, irrespective of holding a good reputation of his own, he will be prepared to pay for the granting of the trademark rights.

(vi) Duty to cooperate

The judgment I R 103/00 caused the German legislator to undertake a comprehensive overhaul of the regulations concerning taxpayer documentation and cooperation in the area of transfer prices. The crux of the

⁵³ See section 6.5.3 below.

⁵⁴ Bundesfinanzhof, Judgment of 9 August 2000 I R 12/99, BStBl II 2001, 140.

decision was determination of arm's length price for products that a German distributor company had purchased intra-group. In addition to the questions of how these prices are to be set, what data is to be referred to or used as the basis for the setting of the transfer prices, and how to deal with a possible range of different products, the prime issue here concerned clarification of the cooperation duties to be met by the taxpayer. The significance of this judgment was underlined not only by its length. It was also apparent in the fact that it took four years for the tax authorities to recognise it officially⁵⁵ and put forward a proposal for legislation.⁵⁶

The case concerned a group-affiliated distributor company generating gross profit margins on product sales in Germany of 18 to 24 per cent. The tax authorities saw fit to adjust the margins to 26 to 28 per cent. The Federal Tax Court criticised this on the grounds that the estimate by the tax court was in breach of the rules of procedure in that the tax court saw the use of anonymous data as generally impermissible. According to the court rulings of the Federal Tax Court the utilisation of anonymous data is permissible. Should doubt exist as to the quality of data collection, however, the legal relevance of this data can be lowered.

Moreover, the Federal Tax Court denied the duty of the taxpayer to provide evidence for appropriate transfer prices in the disputed case, stating that at the time of the ruling, no specified documentation and recording duties were in place. These statements have since become obsolete in Germany, the legislator having introduced new regulations in this respect in 2003.

In respect to methodology, the Federal Tax Court declared that an in-house arm's length comparison cannot be carried out on the basis of the resale price method if the comparison involves only three non-affiliated manufacturers, the purchases do not cover all the relevant years, and the purchases constitute a maximum of 5 per cent of the overall turnover. And the Federal Tax Court also addressed the question as to whether, in the event of a range of possible transfer prices resulting, the estimate must be oriented to the high end, the low end or a median value. For the setting of transfer prices in Germany the considerations of the Federal Tax Court on this matter have been superseded, as the German legislator

⁵⁵ Bundesfinanzhof, Judgment of 17 October 2001 I R 103/00, BStBl II 2004, 171; resolution of 10 May 2001, *Bundesfinanzhof Rulings* (journal) 194, 360.

⁵⁶ See sections 6.3.2 and 6.4.2 above with respect to the initiative regarding documentation and penalty provisions.

set out detailed regulations on this in the 2008 Corporate Tax Reform.⁵⁷ Pursuant to these, the margin of possible arm's length values, for example, must be narrowed down if the setting of transfer prices is to be based on values of limited comparability. The pronouncements concerning losses given in the Federal Tax Court judgment I R 103/00 have already been dealt with above.⁵⁸

(vii) Transfer prices for goods

As far as is apparent, the Federal Tax Court has made statements on transfer prices for goods in only three recent judgments. These were discussed above in the context of sustained losses (I R 3/92, I R 22/04, I R 103/00), so that the reader may be referred here to those judgments.⁵⁹

(viii) Concerns based on European law

In view of the sense of 'adjustment of income', discussions have been in progress in Germany concerning a possible conflict of section 1 of the FTA, not only since the decision of the European Court of Justice in the SGI matter.⁶⁰ The 'adjustment of income' (section 1 of the FTA) is limited to business transactions with foreign countries, so that due to the existing differences between the various correction formulas both in application and also in their legal consequences, many doubts exist as to whether the regulations of section 1 of the FTA are compatible with European law. Particularly apparent is the difference in connection with transfers of right of use, which in the cross-border context are covered by section 1 of the FTA, while in the domestic context these are exempted from correction. In addition, also reference to the arm's length principle and its implementation in detail (median value, the required transparency of information, and the provisions for subsequent price adjustment) give rise to unequal treatment of comparable facts and circumstances which differ only in their domestic or foreign context. These differences are particularly striking in connection with the regulations on shift of functions. If no third party values of limited

⁵⁷ See section 6.4 above. ⁵⁸ See section 6.5.3 above.

⁵⁹ Bundesfinanzhof, Judgment of 17 February 1993 I R 3/92, BStBl II 1993, 457; Judgment of 17 October 2001 I R 103/00, BStBl II 2004, 171; Judgment of 6 April 2005 I R 22/04, BStBl II 2007, 658.

⁶⁰ *Société de Gestion Industrielle (SGI) v. État belge* (C-311/08), European Court of Justice, Judgment of the Court (Third Chamber) of 21 January 2010 (reference for a preliminary ruling from the Tribunal de première instance de Mons, Belgium) [2010] OJ C63/8.

comparability can be found, the taxpayer is to base his transfer pricing on a hypothetical third-party comparison looking at the profit potential for each party for the function to be transferred. Moreover, it should not be overlooked that business relationships involving foreign transactions between related parties are subject to higher documentation obligations while also standing under particular sanctioning mechanisms (section 90(3) of the FC; section 162(3), (4) of the FC; and Ordinance regarding the Documentation of Profit Attributions). Doubts concerning the compatibility of section 1 of the FTA with European law have also been expressed by the Federal Tax Court⁶¹ and the Tax Courts of Düsseldorf and Münster,⁶² though from the German perspective no presentation has yet been made before the European Court of Justice.

6.6 Transfer pricing disputes: bilateral and multilateral approaches

6.6.1 Approaches employed

DTA mutual agreement and arbitration procedures

According to the relevant double taxation agreement (DTA) articles, a mutual agreement procedure (MAP) can be initiated if there is a possibility of double taxation occurring which the nation concerned cannot prevent through unilateral measures (mutual agreement procedure in the narrower sense). Such procedures are designed to avoid double taxation and in cases of transfer prices are aimed at achieving bilateral agreement in contractually determining an adjustment of profit. Initiation of a MAP is also possible in order to remove (i) difficulties or doubts arising in the interpretation or application of a DTA ('consultation procedure') or (ii) cases of double taxation which are not dealt with by double taxation agreements.⁶³ A MAP may further be initiated if

⁶¹ Bundesfinanzhof, Judgment of 29 November 2000, BStBl II 2002, 720; Bundesfinanzhof, Judgment of 21 June 2001, *Bundesfinanzhof Rulings/not to be published* (journal) 2001, 1169.

⁶² Tax Court of Düsseldorf, Judgment of 19 February 2008, *Tax Court Rulings* (journal) 2008, 1006; court case waived by Bundesfinanzhof, Judgment of 29 April 2009, *Bundesfinanzhof Rulings/not to be published* (journal) 2009, 1648; Tax Court of Münster, Judgment of 22 February 2008, *Tax Court Rulings* (journal) 2008, 923, revision withdrawn.

⁶³ Ministry of Finance, Memorandum on international mutual agreement and arbitration procedures in the field of taxes on income and capital, Communication of 13 July 2006 IV B 6-B 1300-340/06, BStBl I 2006, S 461, No. 1.2.1; in comparison to the mutual agreement procedures, consultation procedures are of considerably lower significance.

a DTA does not include a corresponding article. However, MAPs may not result in the case being resolved, although from a German perspective in many cases they lead to a successful outcome.⁶⁴ It is possible for the negotiations to end without a result or for the outcomes achieved to be implemented incompletely or not at all. A problem commonly apparent in this process is that the procedures frequently last too long and there is no obligation for the parties to come to a consensus.

Arbitration procedures provide for the extension of a MAP in the form of a 'procedure for the binding resolution of disputes concerning the interpretation or application of DTAs by one or several arbitrators' on application by the taxpayer. This only applies if the competent authorities are not able to come to an agreement within a certain given period. The OECD gives this process a maximum duration of two years. The period normally begins when the case in dispute (and its associated documents) is submitted. However, this can only happen once double taxation has actually occurred.

According to the OECD model, arbitration procedures can be applied to all unresolved issues of the case. However, this does not hold for issues already decided upon by a court in one of the nations involved. Nor is it possible to pursue an arbitration procedure and domestic appeal in parallel. Rather, the domestic appeal proceedings have to be interrupted until the arbitration court has come to a decision. The taxpayer then has the possibility of either accepting the arbitration decision and waiving the domestic appeal or rejecting it and continuing with the domestic appeal procedure.

EU arbitration procedure

The articles of the EU Arbitration Convention provide for a MAP in the narrower sense only with respect to profit allocation issues between associated enterprises and profit attribution to permanent establishments. This includes also profit adjustments arising from financial transactions including loans and loan conditions provided that they are based on the arm's length principle.⁶⁵ If the contracting states are unable to come to an agreement in a MAP based on the Arbitration Convention (phase 1), the procedure has then to be continued under the conditions of an arbitration procedure according to the provisions of the Arbitration Convention (phase 2).

⁶⁴ German Bundestag, printed matter 16/8027 of 11 February 2008, p. 7.

⁶⁵ Revised Code of Conduct, 2009/C322/01/01, [2009] OJ C322/2, no. 2.

Table 6.9 German MAP statistics for the 2009 reporting period

| Year MAP case was initiated | Opening inventory on first day of reporting period | | Initiated during reporting period | | Completed during reporting period | | Closed or withdrawn with double taxation during reporting period | | Ending inventory on last day of reporting period | | Average cycle time for cases completed, closed or withdrawn during reporting period (in months) | |
|-----------------------------|--|-----------|-----------------------------------|----------|-----------------------------------|----------|--|----------|--|-----------|---|----------|
| | OECD | Non-OECD | OECD | Non-OECD | OECD | Non-OECD | OECD | Non-OECD | OECD | Non-OECD | OECD | Non-OECD |
| 2003 or prior | 39 | 11 | | | 18 | 2 | 1 | 1 | 20 | 8 | N/A | N/A |
| 2004 | 25 | 2 | | | 3 | 0 | 1 | 0 | 21 | 2 | | |
| 2005 | 44 | 4 | | | 8 | 1 | 2 | 0 | 34 | 3 | | |
| 2006 | 96 | 4 | | | 27 | 1 | 3 | 0 | 66 | 3 | | |
| 2007 | 123 | 5 | | | 38 | 0 | 0 | 0 | 85 | 5 | | |
| 2008 | 162 | 4 | | | 24 | 0 | 3 | 0 | 121 | 4 | | |
| 2009 | | | 174 | 3 | 5 | 0 | 1 | 0 | 167 | 4 | | |
| Total | 489 | 30 | 174 | 3 | 123 | 4 | 11 | 1 | 514 | 29 | | |

6.6.2 Mutual agreement and arbitration procedures according to DTAs

Germany has included the possibility of applying for the initiation of a MAP in numerous DTAs.⁶⁶ Here, the application can be submitted to the tax authority locally responsible or to the Bundeszentralamt für Steuern (Federal Central Tax Office).⁶⁷ The application can be made also if an appeal is pending according to German tax law or the law of another nation or legal redress has not yet been exhausted, and has to be made without delay. Many DTAs contain specific time limitations which have to be taken into account. Where no time limitation is stated in a DTA, the German tax authorities do not in principle accept the initiation of a MAP if a period of more than four years has elapsed between notification of taxation and application by the taxpayer (see Table 6.9).

The precondition for making an application to initiate a MAP is that taxation is not in line with the terms of a DTA. Where the application is addressed to the German tax authorities, the tax administration first has to examine whether the double taxation can be removed by way of a domestic measure. If so, the German tax authorities are required to undertake such measures. Otherwise, the Federal Central Tax Office has to initiate a MAP, provided the relevant prerequisites are given. In the case that the MAP is initiated by a foreign tax authority, the German Federal Central Tax Office only examines the formal preconditions (see Table 6.10).

Assuming that a MAP goes ahead, the necessary facts and circumstances are to be determined *ex officio* by the locally responsible tax authorities. The applicant is obliged to cooperate in this process. Moreover, the results of the investigations by the foreign tax authority are to be considered. Over and above this, the DTA exchange of information clauses and the provisions of the EG Amtshilfegesetz (European

⁶⁶ Ministry of Finance, Memorandum on international mutual agreement and arbitration procedures in the field of taxes on income and capital, Communication of 13 July 2006 IV B 6-B 1300-340/06, BStBl I 2006, S 461, no. 2.

⁶⁷ The Federal Ministry of Finance has transferred the responsibilities for tasks of a competent authority with respect to MAPs according to DTA and the Arbitration Convention to the Federal Tax Office (s. 5(1) no. 5 of the Finanzverwaltungsgesetz, Tax Administration Act (TMA)). See Federal Ministry of Finance, tasks of the Central Federal Tax Office according to s. 5(1) no. 5 of the TMA; Communication of 20 June 2011 IV B 5-O 1000/09/10507-04, BStBl I 2011, S 674. The Federal Tax Office acts in agreement with the responsible local authorities. It is the task of these authorities to implement the MAP domestically.

Table 6.10 *Development of German MAP inventory for the period from 2006 to 2009*

| Reporting period | Opening inventory on first day of reporting period | Initiated during reporting period | Completed during reporting period | Closed or withdrawn with double taxation during reporting period | Ending inventory on last day of reporting period |
|------------------|--|-----------------------------------|-----------------------------------|--|--|
| 2006 | 444 | 212 | 155 | 25 | 476 |
| 2007 | 476 | 186 | 125 | 11 | 526 |
| 2008 | 527 | 177 | 171 | 14 | 519 |
| 2009 | 519 | 179 | 127 | 12 | 543 |

Communities Administrative Assistance Act) are also to be taken into account in the MAP. The tax authorities concerned can draw up together a joint report on the result of these investigations proposing also a joint assessment of the facts and circumstances and basic figures for obtaining a solution. If it is possible for mutual agreement to be found with the taxpayer by other channels, it is not necessary for a report to be prepared. Irrespective of this, the taxpayer can submit applications in the framework of the MAP and make statements on the facts and legal questions under consideration. The participants in the MAP, however, are only the tax authorities of the contracting states. They are responsible for achieving mutual agreement and notifying the taxpayer covered by the DTA about the outcomes.

In order to implement the results of the MAP, the tax assessment notice has, if necessary, to be amended. In this context, the German Abgabenordnung (Fiscal Code) states that the period in which the tax assessment notice can be subject to amendment shall not be deemed to terminate before the end of one year following the effective date of mutual agreement (section 175 of the Fiscal Code). The precondition for amendments is that the applicant declares his consent to the implementation of the MAP, pending appeals are withdrawn and the applicant agrees to forego making any appeals with respect to the outcome of the MAP itself. In the event of a MAP failing to reach agreement, the locally responsible tax authority is obliged to examine whether double taxation

can be avoided by reference to factual inequity. German tax authorities will not consider measures to achieve equitable treatment if the taxpayer has not properly observed formal administrative requirements, has failed to observe duties of cooperation, or has made false statements contributing to the double taxation that has occurred.

In a (small) number of its DTAs, Germany has included mutual agreement provisions entailing binding arbitration. A first example of this is the DTA with France,⁶⁸ according to which an arbitration panel can be consulted if no mutual agreement can be found within two years following submission of the application concerned (Article 25a of the France DTA). A similar option is available also in the case of the Canada DTA.⁶⁹ According to this treaty, difficulties or doubts concerning its interpretation or application which cannot be dealt with by the competent authorities can, by mutual consent of the competent authorities, be submitted to an arbitration panel (Article 25(6) of the Canada DTA).

The DTA arbitration clauses negotiated with Austria, Sweden and the United States, however, are different. According to the Austria DTA,⁷⁰ when it comes to arbitration the contracting states are required to refer the case to the European Court of Justice if difficulties or doubts arising in interpreting the DTA cannot be resolved by the competent authorities within three years of initiating the process on application by the taxpayer. In a comparable way, the United States DTA prescribes a mandatory arbitration procedure. However, in contrast to Austria, the United States DTA details regulations for performing the obligatory arbitration procedure. It begins in principle two years after initiation of the procedure unless the competent authorities have previously agreed on a different point in time (Article 25(6) of the United States DTA).⁷¹

According to the Sweden DTA,⁷² application of the 'European Convention for the Peaceful Settlement of Disputes'⁷³ is prescribed in the event that the contracting states cannot come to any agreement in the MAP (Article 41(5) of the Sweden DTA). Accordingly, disputes under international law are in principle resolved before the International

⁶⁸ France DTA of 20 December 2001, BGBl II 2002, S 2372.

⁶⁹ Canada DTA of 19 April 2001, BGBl II 2002, S 671.

⁷⁰ Austria DTA of 24 August 2000, BGBl II 2002, S 735.

⁷¹ United States DTA of 4 June 2008, BStBl I 2008, S 766.

⁷² Sweden DTA of 14 July 1992, BStBl I 1994, S 422.

⁷³ Council of Europe, ETS No. 023, European Convention for the Peaceful Settlement of Disputes, Strasbourg, 29 April 1957.

Court of Justice in The Hague. But the contracting states can equally agree to convene an arbitration court.

6.6.3 Mutual agreement and arbitration procedures according to the EU Arbitration Convention

Within the EU the initiation of a mutual agreement or arbitration procedure can also be based on the EU Arbitration Convention in the case of profit adjustments between associated enterprises or the attribution of profits to permanent establishments.⁷⁴ Legally, the arbitration agreement has the status of a multilateral treaty under international law standing at the same level as a bilateral DTA.⁷⁵ As a consequence, disputes concerning transfer pricing may be resolved by both the Arbitration Convention and the DTA arbitration provision. As these procedures cannot be pursued in parallel, the (first) initiated process should have priority. This priority is normally without significance for the conducting and implementation of the procedure since the German Federal Ministry of Finance applies the relevant rules likewise for both procedures.⁷⁶ In terms of content, however, the provisions of the DTAs and the Arbitration Convention are identical with the result that the taxpayer may consider whether to base his application on potentially more favourable provisions of a DTA. In this case a change to the more favourable procedure should be possible as long as it is within the relevant limitations period.⁷⁷

From the German perspective, dispute resolution on the basis of the EU Arbitration Convention has proved to be a real success story. As far

⁷⁴ See Chapter 5 'European Union'.

⁷⁵ Federal Ministry of Finance, Memorandum on international mutual agreement and arbitration procedures in the field of taxes on income and capital, dated 13 July 2006 IV B 6-B 1300-340/06, BStBl I 2006, S 461, 1.1.2.

⁷⁶ *Ibid.* 12.1.2.

⁷⁷ Where no deadline for application has been laid down in the applicable DTA the German tax authorities do not approve initiation of an arbitration agreement if a taxpayer has allowed a period of more than four years from notification of taxation to elapse before applying if no specific circumstances have ruled out earlier application, see Federal Ministry of Finance, Communication of 13 July 2006, BStBl I 2006, 461, no. 2.2.3; according to the Arbitration Convention this application is to be submitted within a period of three years from first notification of the taxation that has led to or could lead to double taxation. This period starts upon receipt of the first tax assessment notice leading to double taxation (Art. 6(1) sentence 2 of the Arbitration Convention); moreover see Federal Ministry of Finance, Communication of 13 July 2006, BStBl I 2006, 461, no. 11.2.1.

as is known, there have only been three cases in the EU which have proceeded to the second level of the relevant procedure (arbitration level). Although the number of mutual agreement procedures has remained consistently high, mutual agreement in the EU is achieved within the prescribed period by almost all parties entering into a MAP. This means that for all those opting for the procedure according to the EU Arbitration Convention, double taxation is effectively cancelled out.

6.7 Pricing agreements

6.7.1 Subject matter

To minimise time-consuming disputes regarding the appropriateness of tax transfer prices between the taxpayer and the tax authorities, for the past few years the Federal Republic of Germany has made available the instrument of the advance pricing agreement (APA). With binding effect within the agreed terms, an APA makes it possible to fix:

- (a) the transfer pricing method(s) to be employed,
- (b) for a particular type of transaction, and
- (c) for a particular period of time,

with reference to the international allocation of income among the affiliated companies of a multinational enterprise. The same applies in the case of APAs regarding the attribution of profits to permanent establishments based on the arm's length principle. Generally, the parties to an APA agree on a range of appropriate transfer prices or margins that are acceptable if the enterprise makes use of the agreed transfer pricing method. With a view to future transactions it is furthermore necessary to lay down certain conditions which affect the nature of the business transactions under consideration significantly, as 'critical assumptions'. Such critical assumptions constitute a specific agreed contractual basis in the relationship between the contracting parties to the APA. These critical assumptions can include, for example, consistent shareholding ratios, and consistent market conditions, market shares, business volumes and sales prices.

Provided that the conditions laid down in an APA are fulfilled, the transfer prices applied are seen as being appropriate. As a result, subsequent audits are limited in scope to the question of whether the taxpayer has kept to the conditions agreed upon and fulfilled his corresponding reporting duties.

Unlike the practice commonly found internationally, the German system does not allow tax agreements between taxpayers and the German tax authorities. However, on the basis of a DTA containing a clause on mutual agreement procedures in line with Article 25 of the OECD Model Tax Convention or Article 6 of the EU Arbitration Convention, concluding a mutual agreement is not only permissible in order to resolve disputes concerning transactions that have already taken place (see section 6.6 above) but may also cover future transactions and be concluded in advance.⁷⁸

Under international law, mutual agreements between Germany and a foreign state are binding with the result that the terms of a mutual agreement and the agreed provisions have to be observed. The instrument at hand in Germany to implement the mutual agreement procedure (in advance) is the binding (advance) ruling. Parties to the application procedure for an APA are the taxpayer (applicant) and the Federal Central Tax Office as 'competent authority'. Parties to the advance agreement procedure itself are the 'competent authorities' of the contracting states and not the taxpayer with the associated enterprise. Parties to the advance ruling are the taxpayer (applicant) and the locally responsible tax office.

Since 2006, Germany has had concrete procedural regulations for carrying out an APA. According to the German perception, the mutual agreement between the competent authorities and the advance ruling between the taxpayer and the locally responsible tax office form together the APA ('Doppelpack'). As a consequence, transfer price rulings can in principle only be given if prior to this a mutual agreement has been concluded. However, in the absence of a DTA the tax authorities may, upon application, make a unilateral commitment if the circumstances appear to allow this and there is justified interest in obtaining such ruling.⁷⁹ A unilateral APA agreed by the taxpayer with a foreign tax authority is not binding for the German tax authorities. The taxpayer, however, can make an application for the German tax authorities to commit themselves correspondingly in the same unilateral way.

⁷⁸ Cf. Federal Ministry of Finance, Communication of 13 July 2006 IV B 6-S 1300-340/06, BStBl I 2006, 461.

⁷⁹ Cf. Federal Ministry of Finance, Communication of 29 December 2003, BStBl I 2003, 742.

6.7.2 Procedure

Since 1 September 2004, the Federal Central Tax Office as competent authority has been responsible for carrying out the APA procedure in Germany (section 5(1) No. 5 of the Finanzverwaltungsgesetz).⁸⁰ This is the office that also concludes the APA with the foreign tax authorities. With respect to the taxpayer, the local tax authorities of the Länder hold responsibility. They give the advance ruling and issue the tax assessment notices accordingly.

APAs are application-dependent. For the purpose of appropriate examination of transfer prices, applicants must inform the tax authorities fully of important facts known to them and assist them in the further clarification of all facts and circumstances of the case. An application requires justified interest on the part of the taxpayer in the conducting and concluding of the APA procedure.

Among the documents and records required in many cases for purposes of carrying out an APA are a description of shareholding ratios, a description of the organisational and operative structure of the group, a description of the operative areas, insofar as is required for the APA, a description of the business relations with associated enterprises (planned contractual arrangements), a description and explanation of the functions and risks assumed, a list and brief description of the main assets (in particular intangibles) of significance to the business relations at issue, a description of the market situation, competition and the business strategy/strategies chosen, a description and assessment of the planned value-added chains, and contributions from the companies involved, and a list of all outstanding tax issues (also in relation to other tax administrations) connected with the transactions to be covered by the APA.

Prior to making the decision on whether to file for initiation of an APA, 'pre-filing meetings' may be helpful. In such a prior meeting, the subject and content of an APA are agreed upon. A further point of discussion concerns the documents that will be required for conducting the procedure. Moreover, the time frame and prospects of agreement with the foreign tax authorities can be explored. Consultants can act in such pre-filing on a no-name basis on behalf

⁸⁰ Moreover, see Federal Ministry of Finance, Tasks of the Federal Central Tax Office according to s. 5(1) no. 5 of the Finanzverwaltungsgesetz (Tax Administration Law), Communication of 20 June 2011 IV B 5-O 1000/09/10507-04, BStBl I 2011, S. 674.

of their clients. In cases such as these, however, any statements made by the tax authorities are not binding.

Decisions with regard to content and area of application lie with the taxpayer. As a result, the taxpayer can make his application in terms of functions, persons or regions, making reference to transactions with particular parties or countries. Any limitations must not be made arbitrarily. Implications for taxpayers in third countries have also to be taken into account. As a rule, the subject matter of an APA relates to agreement on employment of one or several transfer pricing methods for certain transactions or types of transactions. In addition, the prices or margins, arrangements for extrapolation of the agreement within the duration of the APA, or adjustment measures can also be taken up in the agreement. However, the tax authorities make provisions that go beyond the methodology for determining transfer prices dependent on the fact that they are underpinned by critical assumptions.

Example: Enterprise A applies to fix in advance the loan interest rate for an intra-group loan with the help of an APA. If, for example, A is planning to set a variable interest rate based on the development of a particular index such as LIBOR, the premium is dependent on A's creditworthiness. Here, it can be agreed upon that the relevant premium is to be made dependent on the condition that A's rating or creditworthiness does not change. This can be built in via critical assumptions.⁸¹

Typical 'critical assumptions' are, for example, consistent shareholding ratios and consistent market conditions, market shares, business volumes, sales prices (e.g., no drastic changes due to new technology), giving a framework in each case. The German codes of practice also cite consistent conditions, e.g., relating to supervisory rights, customs duties, import and export restrictions, international payment transactions, consistent allocation of functions and risks, consistent capital structure, consistent business model, consistent exchange rates and interest rates, tax levied in accordance with the APA in the other country, no substantial changes to the tax circumstances prevailing in the other country, and corrections to transfer prices by a third-party country not involved in the APA, which have an effect on the APA. In the German view, the taxpayer should put forward suggestions as to the critical assumptions applying to the APA from his perspective. He should also elucidate to

⁸¹ Cf. OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (July 2010) para. 4.125.

what extent the proposed transfer price method allows changes to the critical assumptions to be taken into account. Critical assumptions and the subject matter of the APA must be so interdependent that changes to the critical assumptions are likely to influence or place in question the material agreements of the APA.

In principle, APAs apply to a future time period. They therefore normally begin with the start of the business year in which the APA application is made. Under certain circumstances, the German tax authorities approve an earlier starting point. Negotiations with the foreign authorities on a roll back of the agreement to a period preceding contractual terms are also possible.

The Federal Central Tax Office takes the decision to open an APA procedure. This decision must take appropriate account of the taxpayer's interest. The application's compatibility with German accounting principles, the international enforceability and consistency with economic reality are also factors that play a role. If, for example, it becomes clear that the taxpayer's application is based primarily on an interest in tax avoidance, the Federal Central Tax Office can, in mutual agreement with the highest responsible authority in the Land, reject it. The same applies if the taxpayer refuses to cooperate to the required extent or fails to supply information.

Cooperation, information and flexibility in terms of time are significant not only at the opening of the procedure but for the success of the entire course of an APA. Although the applicant does not actually participate in the agreement as the procedure is in the hands of the Federal Central Tax Office (who concludes the agreement) and the tax authorities of the Länder (which are involved in scrutinising it and deciding upon it), he has a duty to cooperate, to provide information, and to submit documents.

Once an APA has been concluded, it is binding for the tax authorities involved. This depends on the fulfilment of the facts and circumstances constituting the basis of the APA and the critical assumptions. The tax authorities are, therefore, entitled to check whether these conditions are being met in the framework of a (regular) tax audit. If the conditions as set out in the critical assumptions are not fulfilled, the tax authorities are no longer bound by the agreement. On the other hand, the tax authorities are not permitted to deviate from the results of the APA if the audit reveals that the taxpayer has applied it properly. They are also bound by the provisions agreed in the APA even if the taxpayer chooses to employ

deviating prices, margins and transfer pricing methods (and therefore have a right to make corresponding adjustments). The taxpayer, however, is not obliged to realise the transaction as planned and on the basis of which the APA has been concluded. In this case, the APA has no legal consequence.

6.8 Concluding remarks

The arm's length principle as developed at the level of the OECD has long been established in German tax law and will be 'celebrating its fortieth anniversary' in 2012. Unlike the various domestic corrective instruments (in particular the 'hidden profit distribution' and the 'hidden capital contribution') where the legal prerequisites and individual conditions result in large part from corresponding rulings of the Federal Tax Court, over the last forty years this principle has been elaborated in parallel with the work of the OECD by means of general guidelines and specific regulations. The specific regulations concern in particular the application of the arm's length principle to permanent establishments, cost sharing agreements, the posting of employees and the transfer of functions (business reorganisations). Moreover, the obligations of a German national regarding records and cooperation with the tax administration with respect to foreign business relationships are regulated and explained in detail. For these purposes, the legal basis of the arm's length principle in Germany (section 1 of the FTA) to some extent called for correction and amendment. Currently (November 2011) the legislator is working on a further extension of the 'adjustment of income' provision aiming at implementing in German tax law the '2010 Authorised OECD Approach' regarding the attribution of profits to permanent establishments.

Although the constituent elements of the arm's length principle are regulated in detail, the application of this principle to the individual case remains difficult. It is not unusual for taxpayer and tax administration to be of a different opinion with respect to this application in a given situation. According to experience gained in the past, however, in most cases these disputes can be resolved in consultation with representatives of the local tax office or the representatives of the Federal Central Tax Office during final meetings of a field audit. From interviews of tax directors it is known that companies seek to avoid the often long-lasting and cost-intensive domestic court procedures, especially since the result of such disputes is often uncertain. In this

context, however, Germany constitutes no exception. A comprehensive survey of all transfer pricing cases dealt with over the past decade by the courts in Australia, Canada, the United Kingdom and the United States shows that in this period no more than sixteen cases were decided in court.⁸²

More successful instruments appear to be advance pricing agreements and mutual agreement procedures. Following the implementation of a formal APA process in 2005, the APA team at the Federal Central Tax Office has received an increasing number of APA requests from taxpayers per year. Although the average duration of an APA is some two to three years, such a process makes it possible to fix the relevant conditions of a cross-border business relationship with binding effect within the agreed terms.

Additionally, a consistently high number of double taxation issues are resolved annually under the mutual agreement procedure. Here, the average duration of such proceedings ranges between three and four years. Even if it is not known externally to what extent these proceedings indeed result in resolving the underlying transfer pricing disputes, the reported figures at EU level make it clear that dispute resolution on the basis of the EU Arbitration Convention has proved to be a real success story. Against this background and as is apparent from more recent double taxation agreements (although not all),⁸³ it appears to best serve the practical issues of corporate taxpayers that Germany places particular emphasis on providing for the extension of mutual agreement procedures in the form of a binding resolution of disputes (arbitration procedures).

⁸² Cf. J. Roin, 'Transfer Pricing in the Courts: A Cross-Country Comparison' in W. Schön and K. A. Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Berlin/Heidelberg, 2012); A. Oestreicher, 'Comments on Julie Roin "Transfer Pricing in the Courts: A Cross-Country Comparison"; in *ibid.*

⁸³ See, e.g., Agreement between the Federal Republic of Germany and the Principality of Liechtenstein for the Avoidance of Double Taxation and Tax Evasion with respect to Taxes on Income and Property of 17 November 2011; this, however, is not the case in respect of the Agreement between the Federal Republic of Germany and the Republic of Turkey for the Avoidance of Double Taxation and Tax Evasion with respect to Taxes on Income of 19 September 2011, the Agreement between the Federal Republic of Germany and the Republic of Hungary for the Avoidance of Double Taxation and Tax Evasion with respect to Taxes on Income and Property of 28 February 2011, and the Agreement between the Federal Republic of Germany and the Kingdom of Spain for the Avoidance of Double Taxation and Tax Evasion with respect to Taxes on Income of 3 February 2011.