33.

Germany

Introduction

The German legislation stipulates in Section 1 of the Foreign Tax Act the arm's-length principle as the norm for related party transactions. Accordingly, the prices for those transactions have to be settled on these grounds applying, if possible, the traditional transfer pricing methods. The appropriateness of the transfer prices have to be laid out in a documentation, which is regularly requested as part of routine tax audits. The approach of the tax authorities to transfer pricing issues, in particular to acceptable pricing methodologies and competent authority proceedings, is undergoing continual change in response to international developments in these areas.

Statutory rules

The statutory rules on transfer pricing are not found within one integrated section of the legislation but in several provisions in different statutes. However, in the meantime the legislative body has developed the Foreign Tax Act or *Außensteuergesetz* (AStG) as the main source for transfer pricing guidance. Section 1 AStG contains rules on:

- Definition of the arm's-length principle, including the notion that also unrelated parties would have knowledge on all relevant facts and circumstances of the transaction and would act as prudent and diligent business managers. This definition is supplemented by the hypothetical arm's-length principle that shall be applied if the set of comparables does not meet limited comparability requirements.
- Definition of related parties, which means an ownership of 25% or more.
- Establishment of the preference of traditional transaction based methods; and the limitation of profit based methods to cases where the three traditional methods are not appropriate.
- Emphasis on the adjustment of transfer pricing ranges; if no fully comparable data exists, transfer pricing ranges need to be narrowed. When a taxpayer selects a transfer price outside of the range, the adjustment will be made to the median of the range.
- Introduction of the Transfer of Function rules, which leads to the establishment of an exit taxation, if certain functions, risks, assets, and opportunities are relocated.
- General authority to adjust transfer prices that do not meet the arm's-length requirement, including a price adjustment mechanism that allows for adjustments within a ten-year period.

Other important provisions are:

- Section 90, Paragraph 3 of the General Fiscal Code or *Abgabenordnung* (AO) – Documentation requirements for cross-border transactions with related parties, including permanent establishments (PE).

- Section 162, Paragraph 3 of the AO – Consequences of inadequate or missing documentation (assumption of need for profit adjustment, income estimation by use of least favourable point in a price range).
- Section 162, Paragraph 4 of the AO – Penalty of 5% to 10% of profit adjustment (with certain ceilings/restrictions) in case of non-compliance with documentation requirements.
- Section 146, Paragraph 2b of the AO – Penalty of euro (EUR) 2,500 up to 250,000 in case of failure to cooperate with the tax authorities.

The 2008 legislation revised Section 8a of the KStG regarding thin capitalisation rules. These rules have been replaced by a general limitation on interest deductions. The thin-capital rules that restricted the deduction of interest on shareholder loans have been replaced by an interest deduction limitation rule. Under the new rules, the allowable net interest expense is restricted to 30% of taxable income before interest, taxes on income, depreciation and amortisation. There is no limitation on the deductibility of interest in the following circumstances:

- Where the net interest expense is less than EUR 1 million.
- Where the company is not part of a group and interest paid to any one shareholder of more than 25% does not exceed 10% of the net interest expense.
- Where the company is a member of a group, but its borrowings do not exceed the borrowing ratio (as shown by the financial statements under a common accounting convention such as International Financial Reporting Standards or US generally accepted accounting principles) by more than 1% and interest paid to any one shareholder of more than 25% does not exceed 10% of the net interest expense.

Similar principles apply to corporate holdings in partnerships and there are related party and right-of-recourse rules for shareholders to catch back-to-back financing and other perceived abuses. Any net interest expense that has been disallowed on a given year because it exceeds the 30% threshold may be carried forward for relief in future years. The net interest expense is then treated as a net interest expense of the year concerned, with the same conditions applying.

In addition to the adoption of formal statutes by Parliament, the authorities are authorised to issue so-called ordinances (*Rechtsverordnungen*) on specific matters, which need to be approved by the Upper House and have statutory character in that they are binding for taxpayers and tax courts. With respect to transfer pricing documentation, an ordinance was published in 2003, providing guidance and binding interpretation on the type, contents and scope of the documentation required (*Gewinnabgrenzungsaufzeichnungsverordnung – GAufzV*). With respect to Section 1, Paragraph 3 of the Foreign Tax Act, the authorities issued an ordinance specifying further details regarding the transfer pricing rules on cross-border transfer of functions (*Funktionsverlagerungsverordnung – FVerlV*). The ordinance covers details on (1) the terminology of Section 1, Paragraph 3 of the Foreign Tax Act, (2) the valuation to be used with respect to the so-called transfer package, and (3) retroactive price adjustments.

Administration principles issued by the tax authorities

The tax authorities do not have the authority to issue legally binding regulations on transfer pricing matters. They are, however, authorised to promulgate general regulations, decrees on special topics, proclamations, etc. on any issue as considered appropriate, including transfer pricing matters. All such promulgations are binding only on the tax authorities, and this tool is used extensively by the authorities to promote their interpretation of statutory law and court decisions. Accordingly, these promulgations indicate the position of the tax authorities and thus have considerable relevance in tax practice.

From a transfer pricing perspective, the regulations set out below are of particular interest.

On 23 February 1983, the Federal Minster of Finance published the Principles relating to the Examination of Income Allocation in the Case of Internationally Affiliated Enterprises (administration principles). These principles contain the general rules on the international income allocation where related parties are involved as well as an extensive discussion on the rules of law governing income allocation. Also included are positions on various types of intercompany transactions. The original version of the administration principles also contained guidelines on cost-sharing arrangements, methods of adjustment and related procedural aspects, but these sections have been replaced by new regulations (*see below*).

The administration principles generally follow the 1979 Organisation for Economic Co-operation and Development (OECD) Guidelines. They have been under revision for some time to incorporate developments since 1979 and, in particular, to catch up with the current OECD standards.

The 1983 administration principles were changed or amended by the following additional principles:

The revised principles on cost-sharing arrangements published in 1999, the new chapter on international secondments published in 2001, and the revised principles on procedural aspects published in 2005, incorporate the tax authorities' interpretation of questions regarding the documentation of the facts and circumstances that relate to relevant transfer pricing arrangements. Importantly, these principles refer to the requirements to document the appropriateness of transfer prices. Taxpayers' documentation of the appropriateness of transfer prices must be exclusively oriented towards the arm's-length principle and is the core of the administration principles on procedures.

On 13 October 2010, the German Federal Ministry of Finance issued the administration principles relating to the Examination of Income Allocation between Related Parties in case of Cross-Border Transfer of Functions (administration principles on transfer of functions). These principles explain the view of the German tax authorities with respect to terms and definitions as well as examples on how the arm's-length price 'exit charge' for a transfer of function should be calculated. According to the administration principles on transfer of functions, the determination of an exit charge should follow a capitalised earnings or discounted cash flow evaluation, all based on generally accepted evaluation methods. Furthermore, the evaluation has to be performed for each of the two parties involved in the transaction, based on an indefinite capitalisation period, using discounted rates calculated as specified in the principles and setting the transfer price at the median of both evaluation results. If the taxpayer's approach deviates from this general approach, the burden of proof is shifted to the taxpayer. The principles also describe the three main 'escape clauses'. However, it may be difficult to actually apply them in practice as the requirements are set at a high level and the burden of proof for the fulfilment of these requirements is with the taxpayer. In addition, documentation requirements are detailed and non-compliance with these requirements does allow the tax authorities to deviate from the transfer price applied, which may result in significant additional taxes. The administrative principles include some helpful clarifications, e.g. on the shift of a single customer order, centralised order allocation to group entities, replacement of 'old' by 'new' products (and shift of manufacturing tasks for 'old' products to an affiliate), or consequences where the other party terminates an agreement by giving notice. Even if the administration principles are effective from fiscal year 2008 onwards, they state that that part of the regulations is for clarification only and, therefore, will be applied by the German tax authorities to all open cases irrespective of the fiscal year they relate to.

Court cases

Transfer pricing issues historically were settled by compromise or negotiation long before they reached the courts; hence, there have been very few court cases on the subject.

There are two levels of courts, and all cases that are heard by the courts may last several years before a final decision is reached by the Federal Tax Court or *Bundesfinanzhof* (BFH) (i.e. the higher court). Decisions by the BFH establish a binding precedent on the lower tax courts on a particular subject. However, the German tax authorities do not always accept BFH decisions as binding for all similar cases and thus may publish instructions that a certain court case is not to be applied by the tax authorities on other cases.

Most published court cases on transfer pricing issues deal with the interpretation of the arm's-length principle and the tax consequences resulting from a violation of this principle. In substance, 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. The test question commonly asked by the court to establish this is whether a prudent and diligent manager (*ordentlicher und gewissenhafter Geschäftsleiter*), in exercising the required professional diligence, would have applied similar conditions on third party transactions.

One of the most important transfer pricing cases decided by the BFH in the past decades is the judgment on 17 February 1993 (I R 3/92), which was published in the Federal Tax Gazette 1993 II p. 457. This case established an important principle that was summarised by the court itself as follows:

> '… an orderly and diligent manager will, for the corporation managed by him, introduce to the market and distribute a new product only if he can expect, based on a prudent and pre-prepared economic forecast, a reasonable overall profit within a foreseeable period of time with due consideration to the predictable market development'.

The decision covers a variety of aspects, including the treatment of marketing expenses and the permissible scope of start-up losses. In many respects, the decision is significant for German distribution affiliates of international groups, which are in a continual overall loss position. Such a loss-making affiliate should anticipate encountering difficulties in convincing tax auditors that losses incurred over several years would have been accepted in dealing with true third parties.

This decision covered the market introduction of a new product by an already established company and stated that typically a market introduction phase, where losses are acceptable, should not be longer than three years. In contrast to this, a BFH decision dated 15 May 2002 stated that a start-up loss phase resulting from market influences of a newly founded company can be substantially longer on a case-by-case basis. The typical start-up phase of three years is, consequently, regularly extended in case of newly founded companies.

An even higher impact on German transfer pricing practices and procedures results from the BFH decision of 17 October 2001 (I R 103/00, published in the Federal Tax Gazette 2004 II p. 171). Not only does this judgment refine principles established in the case on 17 February 1993, but also it provides substantial guidance on procedural issues, such as the judicial revision of data introduced by the tax authorities, of (secret) comparables, the burden of proof, the consequences of lacking cooperation by the taxpayer, the scope of transfer pricing documentation requirements, as well as the determination of arm's-length transfer prices within acceptable ranges. Further references to this judgment will be made in the following sections. It needs to be understood that the German legislature reacted to this decision, in particular, by introducing statutory transfer pricing documentation requirements in Section 90, Paragraph 3 of the AO and promulgating penalties in cases of non-compliance with these obligations in Section 162, Paragraphs 3 and 4 of the AO. To this extent, the principles of the BFH decision dated 17 October 2001 are no longer unrestrictedly applicable to the years 2003 onwards. However, it should be emphasised that even after the introduction of statutory documentation requirements, the burden of proof for transfer prices not being at arm's length is still with the tax authorities, and that the other findings of the BFH in its 17 October 2001 decision remain in force.

Within its decisions of 27 August 2008 – reconfirmed by the decision of the BFH dated 29 April 2009 – the BFH interpreted the term 'business relationship' under Section 1 of the Foreign Tax Act. A business relationship between related parties shall not exist if a parent company does not sufficiently capitalise its subsidiary but provides the subsidiary with free 'capital replacements', which a third party would not have provided (such as an interest-free loan or a binding letter of comfort). If the subsidiary is not able to perform its business operations without the capital replacements, the provision of such capital replacement is not qualified as a business relationship between related parties and, hence, is not subject to income adjustments according to Section 1 Foreign Tax Act.

One of the regional tax courts, the tax court of Cologne, rendered an important decision on 22 August 2007 on the need of upfront (written) agreements for intercompany transactions. The court states that German national law clearly requires having such agreements in place in order to avoid income adjustments. However, the court also clearly acknowledges that Germany will not be able to uphold such a formalistic position under a double-tax treaty where the emphasis is put on whether – irrespective of the fulfilment of formalities such as written agreements – transfer prices are arm's length. The decision is mostly meant to underline the fact that the German tax authorities generally will not be able to attack transfer prices solely for the lack of intercompany agreements. It is interesting to note that the tax authorities have not appealed the court decision and seem, consequently, to acknowledge its findings.

Nevertheless, in practice it remains advisable to enter into upfront agreements with respect to intercompany transactions.

Another regional tax court of Münster rendered an important decision on 16 March 2006 on the allocation of location savings. According to the court the savings should be shared between the location of a contract manufacturer that operates in an environment with a lower wage level and the entrepreneur.

Burden of proof

As a matter of principle, the taxpayer has to prove compliance with German tax law for all business transactions, including transfer pricing matters. In its aforementioned decision of 17 October 2001, the BFH provides guidance on the allocation of the burden of proof. The taxpayer has to prove the underlying facts of a transaction, which includes presentation of the functions and risks and a description of how the transfer price for the transaction was determined. This also includes, however, an explanation on the appropriateness of the transfer prices applied. Nevertheless, the onus is on the tax authorities to prove that the transfer price is, or is not, arm's length. If the taxpayer does not fully comply with his/her obligation to present all facts, the tax authorities may conclude that the pricing has been determined by the affiliation of the parties; however, the latter does not in itself allow the tax authorities to conclude that the transfer price is not arm's length, and the authorities must still determine the proper pricing by means of a comparability study or an appropriate estimation.

The 2003 legislation has introduced a rebuttable assumption that, in the absence of appropriate documentation, the actual income from intercompany transactions is higher than the income declared. If the taxpayer is not able to refute this assumption, the tax authorities may have to estimate the arm's-length result, and if in this case the income can be determined only within a certain price range, the authorities may use the least favourable end of the price range. This mechanism represents one of the penalty elements for non-compliance with documentation rules, which is a potentially heavy detriment for a taxpayer who has not fulfilled his/her legal documentation obligation. Otherwise, one would benefit from the 17 October 2001 BFH decision, which still provides the right to use the most favourable end of the price range in case of an estimation. From 2008 onwards, however, even in these cases a correction could be made, at least to the median of a range, if the taxpayer had agreed on prices outside of the appropriate range.

However, in this respect even the administration principles on procedures dated 12 April 2005 do not allow the taxpayer to generally choose the most favourable value in a range of transfer prices or margins in the frame of an estimation. The tax authorities require that this exploitation of the range in the sense of the most favourable value for the taxpayer depends on the degree of comparability of the respective third-party data. For this purpose, the tax authorities may narrow the range to the detriment of the taxpayer if an unlimited comparability of all third-party data within the range is not given.

The above rules apply only to the regular price determination process. However, in criminal prosecutions, the case is handed to the prosecution arm of the tax authorities or from there to the State Prosecutor, which will have to prove that the conditions of tax fraud or other criminal offence are met, including the taxpayer's criminal intent.

Tax audit procedures

The German tax authorities do not normally perform tax audits specifically for transfer pricing issues, rather they examine transfer pricing during the normal tax field audits, which are performed at regular intervals. With the exception of small business entities, German enterprises are generally subject to regular tax field audits, which usually cover three to five consecutive years. Almost all tax audits are focusing on transfer pricing, and tighter investigations by tax auditors into transfer pricing issues are occurring in light of extensive new rules and a nationwide transfer pricing programme for tax auditors.

Since the introduction of legal documentation requirements, companies should be prepared to provide the documentation of their cross-border transfer prices within the limits of Section 2, Paragraph 6 of the GAufzV already on receipt of the official advance notice (*Prüfungsanordnung*) of the tax audit. The time limit of 60 days (respectively, 30 days for so-called extraordinary transactions) for submitting this documentation starts in these cases with this official advance notice. However, an unspecified flat request for documentation is not allowed; companies should consider objecting if confronted with such an unspecified flat request.

Duty of taxpayer to cooperate with the tax authorities

The tax authorities may request any information considered relevant to all transactions throughout the audit period, and the taxpayer is obliged to cooperate with the authorities. Where the investigation concerns cross-border transactions, German taxpayers are under an increased obligation to cooperate. Information on foreign affiliated parties must be provided if requested as far as the taxpayer has factual and legal access to the requested data. Where the requested data is not provided, even though the German taxpayer would have had the possibility to obtain such information, the tax authorities are entitled to estimate 'appropriate' transfer prices based on simplified methods, which may result in an adjustment of taxable income.

The 2008 legislation introduced the notion that, if foreign related parties will not disclose information that is relevant for the transfer prices of a German entity, the transfer prices of the German entity can be estimated at the end of the range that is most unfavourable for the German taxpayer.

Documentation requirements

The German rules request documentation as to type, contents and scope of cross-border transactions with related parties, including the economic and legal basis for an arm's-length determination of prices and other business conditions. Documentation must be prepared within a reasonably short period (i.e. within six months after the end of the business year) for extraordinary transactions, such as corporate restructurings as well as material long-term contractual relationships.

Documentation for all types of transactions must be presented to the authorities upon their request, typically in the course of a tax audit. The time limit for presentation is 60 days following the request (respectively, 30 days in case of extraordinary transactions); extensions may be granted for special reasons.

Field audits in practice

Field audits, in most cases, are carried out at the premises of the taxpayer. The tax auditor notifies the taxpayer of the intended visit and the scope of the audit typically some weeks before the audit commences. Depending on the size, complexity and availability of information, an audit may take between a few days and many months, or even years. Effective in 2002, special procedures have been established to allow spontaneous VAT audits with no warning to the taxpayer. Depending on the results, such a special audit may be continued as a regular tax audit covering other taxes, including transfer pricing.

As of 2002, the tax authorities are entitled to access the electronic records of taxpayers, who are required to make their data available. At their election, the authorities may take direct access or may request that the taxpayer process and evaluate data at their specification. Finally, the authorities may also require copies of all data in a form suitable for further processing.

As a result of the field audit, the tax auditor summarises the findings and any tax adjustment considered necessary in a written report. It is common tax audit practice that the tax auditor, before finalising the report, continues to correspond with the taxpayer or his/her advisors to try to settle all the issues of concern. Regularly, a final meeting is held between all parties involved to evaluate the material findings. It should be noted that negotiation is an important element of most tax audits and that in most cases a final settlement is reached by compromise.

In case of internationally affiliated companies, the examination of cross-border transfer prices is increasingly the focus of tax audits. Hence, the tax risks resulting from transfer prices not being at arm's length should not be underestimated, in particular against the background of respective sanctions that may apply in such cases. In this respect, the quality of the documentation of the appropriateness of transfer prices is of particular importance, as it may result in minimising the risk of income corrections. Simply said, the better the documentation of transfer prices with regard to their arm's-length character, the lower the risk of income corrections. In addition, solid transfer pricing documentation may help to shorten the duration of a tax audit.

Revised assessments and the appeals procedure
The tax auditor is not authorised to issue revised assessments for the years under audit. The final report, including suggestions for any tax adjustment, is presented to the local tax office where the revised tax assessments are prepared, usually in accordance with the recommendations of the tax auditor.

The taxpayer may appeal against the revised assessments. If the appeal is denied by the appeal's department of the respective tax office, the taxpayer may appeal at court. Such appeals would be heard first by the regional tax court and then, if admitted, by the Federal Tax Court.

Additional tax and penalties
Any unfavourable transfer pricing adjustment will result in an increase of taxable income, which generally leads to the treatment as hidden dividend distribution. This is taxed with the corporation tax rate of 15% (through 2007, 25%) as well as the trade tax (unless balanced by tax loss carry-forwards). To the extent a transfer pricing adjustment will be treated as a hidden dividend distribution, additional withholding taxes may become due; even if double-tax treaties or supranational law (e.g. the EU Parent-Subsidiary-Directive) provide for reduced withholding tax rates, such reduction may be achieved only by a formal application.

Penalties other than interest charges are generally unknown under the present laws as part of the taxation process and may be an issue in criminal proceedings only. However, with respect to transfer pricing documentation, a penalty regime has been implemented with effect from 2004. In strict legal terms, a surcharge (no penalty for criminal misconduct) between 5% and 10% of a profit adjustment must be raised, with a minimum of EUR 5,000. In case of late presentation of appropriate documentation, the maximum surcharge is EUR 1 million, with a minimum of EUR 100 for each day after the 30/60 days time limit is exceeded. Furthermore, in the course of the audit procedure penalties may be assessed in case of undue cooperation.

Resources available to the tax authorities

Central authority for all international tax matters, including transfer pricing, lies with the Federal Tax Office (*Bundeszentralamt für Steuern*). The Federal Tax Office collects all information and data of relevance for international taxation and transfer pricing issues. This central extensive statistical information is confidential and is available to the tax administration only. In local tax audits, matters of international importance may be presented by the local tax auditor to the Federal Tax Office for review, and expert auditors of the Federal Tax Office with specialisation in transfer pricing or other international tax matters may assume responsibility for respective segments of local tax audits. The Federal Tax Office relies entirely on internal expertise rather than on outside consultants or other experts.

In recent years, the German Revenue has identified transfer pricing as a strategic area of the highest importance, and considerable efforts are being made to strengthen this area, both from a manpower/experience and an organisational point of view. Internationally affiliated taxpayers are being increasingly investigated by tax auditors with special cross-border experience, and that experience includes transfer pricing. The responsibility for larger companies (which typically have international group affiliations) also lies with special regional tax offices, which have an increasing transfer pricing expertise.

Use and availability of comparable information

In determining an arm's-length price, Section 1, Paragraph 3 Foreign Tax Act advises to primarily use the traditional transactional pricing methods: comparable uncontrolled price (CUP) method; resale price method (RPM); and cost plus (CP) method. Profit-related transfer pricing methods are also generally accepted in tax audit practice and their use is supported by the administration principles. The administration principles on procedures explicitly acknowledge that, under certain conditions, the use of other methods may be appropriate. Specifically, the use of the profit split method (PSM) or the transactional net margin method (TNMM) is mentioned for specific cases; the latter can generally be applied if (1) no standard method is applicable, (2) an enterprise carries out only routine functions, and (3) at least a limited comparability exists based on comparable data.

The administration principles also allow companies to apply profit based transfer pricing methods to the extent that useful comparable data cannot be determined on the basis of the traditional methods. However, the application of the comparable profit method (CPM) is explicitly rejected (i.e. transfer pricing methodology must be strictly transactional).

The application of the transfer pricing methods depends inter alia on the structure of the company under review. The German tax authorities differentiate between three categories of companies:

- Companies with routine functions and no considerable contribution to the value chain – allowed methods: standard methods and TNMM; companies with an entrepreneur-type structure (so-called strategy leaders) – allowed methods: standard methods with respect to its affiliates; PSM between companies of the same structure.
- Companies exercising more than routine functions, without having the profile of an entrepreneur – allowed methods: standard methods, determination of transfer prices based on internal planning data with arm's-length profit forecasts.
- Companies having an entrepreneurial profile – allowed methods: any method that leaves in principle the residual profit with the entrepreneur.

Hence, Germany follows the international trend of using profit based transfer pricing methods for the determination of arm's-length transfer prices; however, certain restrictive conditions must be fulfilled. This happened inter alia against the background that it is becoming more and more difficult in competent authority or arbitration proceedings to reject profit-related pricing methods where other countries are applying such methods.

The 2008 legislation describes the concept of the hypothetical arm's-length test when no comparables are available. This concept has originally been established by German courts: Applying the hypothetical arm's-length test, a transfer pricing range is typically seen to be between the minimum price for one party in the transaction and the maximum price for the other party, with the price expectations of the parties based on the net present value of forecasted future income. If no other value can be substantiated by the taxpayer, the mean of the range is taken as the arm's-length price.

Availability

With regard to the availability of published financial data such as company accounts, except for publicly traded entities, few German corporations are inclined voluntarily to publish any meaningful financial data or to comply with general European publication requirements. Owing to the lack of penalties for non-compliance in the past, only a relatively small percentage of German corporations fulfilled the publication requirements. However, an increasing number of German companies have started to publish their financials in databases. Hence, databases have a larger quantitative basis and their meaningfulness for comparability studies is increasing. At the same time, databases contain more detailed company information so that database-supported comparability studies are gaining importance in defending appropriate transfer prices to the tax authorities. However, the administration principles on procedures require that the search process of a database analysis be comprehensible and examinable for a tax auditor. It must not be limited to a mere database screening but requires a manual or qualitative screening. The overall guiding principle is 'quality is more important than quantity of comparables'. Only under these circumstances will the tax authorities accept database-supported comparability analyses.

Secret comparables

In the past, the German tax authorities have relied entirely on self-collected information. However, reflective of the evident international development, they have started to use information available on publicly accessible databases. Still, to the extent the tax auditor resorts to other taxpayers' data for examining the arm's-length character of transfer prices, the taxpayer is not entitled to be informed of this data for reasons of taxpayer confidentiality. As a result, this data has a reduced value of proof regarding income corrections in a tax audit.

Limitation of double taxation and competent authority proceedings

Competent authority provisions are an integral part of the extensive German treaty network, and proceedings normally follow the pattern of Article 25 of the OECD Model Tax Convention. Retroactive adjustments arising from transfer pricing issues, which may result in a reduction of German taxes, may be allowed even where tax assessments have become final and would not, in accordance with domestic tax law, otherwise be allowed. Depending on the complexity and/or importance of the subject matter, a competent authority proceeding may take between a number of months to several years.

The administration principles on procedures explicitly mention that in case of an imminent double taxation caused by transfer pricing corrections of a foreign or national tax authority, the opening of a mutual agreement or EU arbitration procedure may help to remove this double taxation by means of corresponding counter-income corrections. For this purpose, in case of a transfer pricing correction intended by a national tax audit, the company must be immediately informed of this correction so that it can turn to the foreign tax authority and discuss the possibility of a corresponding counter-correction with them. Should the foreign tax authority not agree to such a correction, the taxpayer may apply for a mutual agreement or to the EU arbitration procedure.

Further details on mutual agreement and EU arbitration procedures are set out by the tax authorities in a circular letter of 13 July 2006.

In case of an imminent transfer pricing correction intended by the foreign tax authorities, the German taxpayer is obliged to inform the German tax authorities. Should German transfer prices change correspondingly, such changes would have to be documented. Should the German tax authorities not see themselves in a position to effect the corresponding counter-correction, the company has the opportunity to apply for a mutual agreement or EU arbitration procedure in order to avoid double taxation. In case of a foreign transfer pricing correction, the company must submit all documents relevant to this correction to the German tax authorities.

It should be noted that, although the success of competent authority proceedings depends on the voluntary consensus of both tax authorities involved, the German authorities are unlikely to reject a compromise. In addition, Germany has begun to include in the negotiation of a new tax treaty the position that mutual agreement procedures should contain an arbitration element (i.e. that they cannot end without a binding and final decision to avoid double taxation).

Like all other EU Member States, Germany observes the European Arbitration Convention on Transfer Pricing Matters. The EU Arbitration Convention is based on the Convention 90/436/EEC on the Elimination of Double Taxation in Connection with the Adjustment of Transfers of Profits between Associated Undertakings.

Germany

Advance pricing agreements (APAs)

The attitude of the Federal Ministry of Finance on APAs is generally positive, insofar as the Ministry actively welcomes and supports APAs for transfer pricing purposes in Germany. This has to be seen against the background that the determination of arm's-length transfer prices in an APA serves the avoidance of lengthy disputes between the participating authorities in treating cross-border transfer prices. A further benefit of an APA is that it may considerably shorten the length of tax audits because the transfer pricing system as such is not challenged. In addition, APA reporting requirements and documents of an APA can be used to fulfil German transfer pricing documentation requirements.

However, it should be emphasised that the Federal Ministry of Finance is typically not prepared to grant unilateral APAs in transfer pricing issues because unilateral APAs have no binding effect on the other country concerned. Therefore, the German tax authorities are instructed to grant APAs only on a bilateral or multilateral basis. This necessitates the respective other country to participate in the APA procedure and effecting APA proceedings on the legal basis of Article 25 OECD Model Tax Convention in the sense of a (anticipated) mutual agreement procedure.

Germany also has APA guidelines in the sense of formal regulations on how to apply for, negotiate and grant an APA. On 5 October 2006 Germany's Federal Ministry of Finance released a circular on bilateral and multilateral APAs which was designed to facilitate the processing of APAs and to establish more certainty for taxpayers.

Within the Federal Ministry of Finance, the competence for APA applications and for granting an APA has been centralised in one department and is no longer allocated over several state-specific departments. This centralised department is located within the Federal Tax Office in Bonn. It has to be considered that in addition to the Federal Ministry of Finance, the local tax office (including the tax auditor) is regularly involved in an APA procedure. In addition, expert auditors for international tax issues from the Federal Tax Office may be involved in the proceedings.

In 2007, Germany introduced the following fees for its APA programme:

- In general, the fee for an APA amounts to EUR 20,000 (basic fee), which becomes due if an APA is not issued as set out in the application process. In case of multilateral APAs, the fee incurs for each country involved.
- The fee for an extension of an already existing APA amounts to EUR 15,000 (extension fee).
- Amendments to an APA application incur a fee of EUR 10,000 (amendment fee).
- Reduced fees are possible in cases concerning small enterprises.

Finally, the German tax authorities closely examine any unilateral APA granted by a foreign tax authority that has detrimental tax effects in Germany, unless the German tax authorities themselves actively participated in the APA process.

Anticipated developments in law and practice

Law

The German government intends to extend the application of Section 1 Foreign Tax Act (e.g. application of the arm's-length principle, hypothetical arm's-length principle, transfer of functions regulations) to permanent establishments and partnerships. In this context, it is also intended to implement the Authorised OECD Approach (AOA) for permanent establishments in Section 1 Foreign Tax Act Furthermore, the government is also working on additional ordinances.

The German tax authorities are also continuing their work on a revision of the administration principles following international developments. The administration principles have been revised regarding Chapters 7, 8 and 9 via new decrees. In a future step, the government intends to revise Chapter 5 (intangible assets). As can already be seen from the administration principles on procedures dated 12 April 2005, it is expected that in a continuing revision of the 1983 administration principles, Chapter 3 – which deals with the supply of goods and services – will support the application of profit based methods for the determination of transfer prices under certain circumstances. Here, German tax authorities increasingly follow international trends.

Practice
Further changes can be observed in the approach of the German tax authorities to transfer pricing issues. As practical training and experiences of tax auditors are increasing, the profile of transfer pricing issues in tax audits is raised. At the same time there is a noticeable trend that the tax authorities are developing their own ideas, such as the concept of the hypothetical arm's-length principle, the application of the exit tax concept, or the limited use of comparable data.

These trends together with the increasing number of transfer pricing audit has led to an increasing number of competent authority, arbitration proceedings and APAs.

Liaison with customs authorities
In the past, income tax and customs authorities normally worked independent of each other, with little or no communication or exchange of information. However, this is gradually changing, and it can no longer be excluded that transfer pricing adjustments may result in a reassessment of customs duties, or vice versa.

OECD issues
Germany is a member of the OECD and has approved the OECD Guidelines on transfer pricing despite having previously expressed reservations on certain sections of the guidelines, such as those dealing with profit based pricing methods.

Joint investigations
The tax treaty provisions and additional EU provisions on the exchange of information, competent authority, arbitration and consultation proceedings provide a procedural framework for the German tax authorities to join another country in a joint investigation of a multinational group for transfer pricing purposes. For practical reasons (e.g. lack of manpower and language problems), such simultaneous audits are likely to be restricted to exceptional cases. Currently, there is close communication with other EU Member States and the US Tax Administration on issues of mutual interest, and this will impact on alliances for joint audits.