

Data in Support of Transfer Pricing - Quantification Requirements to Support Deductions in Germany

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A. Introduction: Transfer Pricing in Germany

A German taxpayer has a general duty of cooperating with the German tax authorities in the determination of its income as well as a duty to provide documentation in support of its tax positions.¹ This duty is increased in cases involving cross-border aspects,² particularly with related companies, under the assumption that the taxpayer has greater access to such information than the tax authorities who are limited in their ability to obtain tax information from foreign countries.

In a 2001 decision³, the German Federal Tax Court limited this duty of cooperation somewhat by stating that the regulations existing at the time of the decision only imposed an obligation on taxpayers to provide existing documents but did not require the creation of new ones. In response to this decision, a new provision was added to the German Fiscal Code (Abgabenordnung, AO) in 2003 which expanded the duty of cooperation in transfer pricing cases to include the *creation* of documents specifically for the purpose of supporting transfer pricing policies.⁴

Therefore, under German law, taxpayers are not merely required to provide documents which they happen to have prepared in regard to the pricing of transactions with related foreign parties, rather, they also are required to create additional documents to support determination of such pricing.

B. German System of Supporting Data for Transfer Pricing in General

The legal basis for the duty to provide supporting data in regard to transfer pricing cases is a section of the AO which explicitly specifies the records a taxpayer must keep in order to support the transfer prices and other business conditions applicable to transactions with affiliated companies. Other important legal provisions are contained in the Foreign Relations Tax Act (*Aussensteuergesetz*, AStG) in which the principles for determining acceptable transfer prices are laid

Peter H. Dehnen
Rechtsanwalt
Fachanwalt für Steuerrecht
S.L.C. (Washington, D.C.)

Prinz-Georg-Straße 91
D-40479 Düsseldorf

+49 (0)211 44 97 07
+49 (0)211 44 97 722
peter.dehnen@dehnen.de

www.dehnen.de

¹ Sec. 90 (1) AO.

² Sec. 90 (2) AO.

³ BFH decision 17. October 2001, I R 103/00, BStBl. II 2001, 765

⁴ Sec. 90 (3) AO.

down⁵. Also applicable are Regulations Regarding the Documentation of Profit Allocations (*Gewinnabgrenzungsaufzeichnungsverordnung*, GAufzV) which specify details of the information necessary for recording the economic and legal basis of the transfer pricing determination, as well as a decree of the German Finance Ministry on the application of the obligation to provide supporting data in regard to transfer pricing cases.⁶

Within the German tax system, the use of administrative decrees to explain and solidify the application of legal provisions has become particularly popular in regard to transfer pricing issues⁷: In regard to the documentation duty described above, for example, while the AO sets forth the economic and legal basis of transfer pricing determinations in 1 paragraph and the GAufzV sets forth clarifying regulations in 8 paragraphs, the decree issued by the Federal Finance Ministry comprises 42 pages. While such decrees do not have the same applicability as laws and regulations, they represent the instructions which the tax authorities must follow in applying the law and can only be challenged by taxpayers through judicial proceedings. Therefore, in order to satisfy all of its documentation obligations, a taxpayer involved in transactions with related companies in other countries must familiarize itself, and develop a system for complying with, all of the relevant legal obligations including those set forth in the Finance Ministry decrees.

1. Necessary Documentation

The records which must be created for transfer pricing purposes must document the relevant facts as well as the appropriateness of the determined transfer prices⁸. Documentation of the facts includes recording the nature, complexity and execution of cross-border business transactions carried out with related companies in other countries. Documenting the appropriateness of the transfer prices used is not limited to the level of prices but rather also includes showing that the method chosen for determining the prices is appropriate as well as the reasons for such presumption. Furthermore, details regarding business conditions, profit allocations and margins which third parties would have expected in comparable transactions must also be documented.

⁵ Sec. 1 Foreign Relations Tax Act (*Außensteuergesetz*, or AstG).

⁶ Decree on the principles for the examination of income allocation between related parties with cross-border business relationships in regard to investigation and cooperation duties and adjustments as well as competent authority and EU arbitration proceedings (Administrative Principles – Procedure (*Schreiben betr. Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen nahestehenden Personen mit grenzüberschreitenden Geschäftsbeziehungen in Bezug auf Ermittlungs- und Mitwirkungspflichten, Berichtigungen sowie auf Verständigungs- und EU-Schiedsverfahren (Verwaltungsgrundsätze-Verfahren)*, 12 April 2005 (BStBl. I S. 570).

⁷ On the Application of Sec. 1 AStG, eight decrees have been issued to date, a ninth issue already being issued as a draft.

⁸ Sec. 1 GAufzV.

The contents of documentation regarding transfer prices is divided into the following categories:

- **general information** such as ownership, organisational and operative structures within the affiliated group, descriptions of the taxpayer's activities and business strategies, overviews of the contracts on which the business relation is based, and other similar information;
- **information regarding the specific business relationship** such as the nature and extent of transactions within the affiliated group;
- a **functional analysis** of the various members of the affiliated group, particularly those involved in the transactions under review;
- information regarding the **allocation of risks** within the affiliated group; and
- a **transfer pricing analysis** including the basis for the chosen pricing method and how the method used led to the charging of appropriate arm's length prices.⁹

2. Form and Timing

Generally, the above-mentioned records must be made available in written or electronic form in such a manner that the tax authorities are able to investigate the relevant facts within a reasonable period of time.¹⁰ While no clear regulations exist as to when such documents must be created, it must be made available within 60 days following a request by the tax authorities, which generally occurs within the scope of a tax audit. Since it may be difficult to create the necessary documents within this 60-day period, it is generally in a taxpayer's interest to create the documents, at the latest, upon receipt of notice regarding a planned tax audit. Regardless of when the documents are actually created, they must be maintained for a period of 10 years following the fiscal year of creation.¹¹

Special regulations apply to extraordinary business transactions such as restructurings within the affiliated group, the conclusion or amendment of long-term contracts which are significant for the entire group, transfers of business functions or changes in the risk allocation within the group.¹² Such transactions must be documented "promptly"¹³ -- which is generally interpreted as being

⁹ Sec. 4 GAufZV.

¹⁰ Sec. 2(1) GAufZV.

¹¹ Sec. 147 (3), (4) AO.

¹² Sec. 3 (2) GAufZV.

¹³ Sec. 3 (1) GAufZV.

not longer than 6 months after the end of the fiscal year in which the business transactions were carried out – and must be provided within 30 days following a request by the tax authorities.

C. Special German Rules for Transfers of Business Functions Abroad

The Business Tax Reform Act of 2008 introduced special rules for the pricing of business functions transferred to affiliated companies in other countries. The legislative intent of these new rules was to subject German-made assets to German taxation and to avoid a decrease of German tax revenue caused by relocation of such assets abroad and therefore constitutes the imposition of an exit tax on income which might otherwise have been realized in Germany.

The new rules applicable to transfers of business functions abroad diverge substantially from the pricing of other transactions as well as from international standards such as those of the OECD and therefore create significant increases in the data-provision and documentation burdens of affected taxpayers. Furthermore, the regulations and other guidelines which have been adopted to interpret the statutory amendment are so extensive that most businesses will have a difficult task in applying them. Finally, these rules apply in addition to the standard transfer pricing regulations, thereby further increasing the documentation burden of affected German companies.

1. Climax of the Legislative Process

The main provision in regard to transfers of business functions abroad is contained in Section 1(3) 9 AStG which states that

If ... a function, together with the corresponding opportunities and risks as well as the transferred or relinquished assets and other advantages, is transferred abroad (“function transfer”), the taxpayer must determine the price range on the basis of a transfer of the function as a whole (“transfer package”) taking into account the capitalization rates adequate for the functions and risks transferred.

The regulations which were adopted to interpret this provision (*Funktionsverlagerungsverordnung*, FVerIV) comprise 13 paragraphs and specify how the transfer price of a business function is to be determined¹⁴. Additionally, the Ministry of Finance has issued a draft decree setting forth its understanding as to how the regulations (FVerIV) are to be applied.¹⁵ This decree, which consists of 72 pages, contains the interpretation of provisions which are not included in either the AStG or the FVerIV and, in the case of a so-called “doubling” of a business function, even adds a

¹⁴ Regulations Regarding the Application of Sec. 1(1) AStG to Transfers of Business Functions Abroad (*Funktionsverlagerungsverordnung*, FVerIV).

¹⁵ Draft rules for the determination of income between related parties in regard to transfers of business functions abroad (*Verwaltungsgrundsatz Funktionsverlagerung* 2009).

provision which was expressly excluded from the Regulations. Generally, a transaction which results in the doubling of a business function is not considered a “transfer” under the AStG or the FVerIV with the result that no transfer prices for such transaction need be developed. Through its definition of “doubling” and its differentiation from the concept of “transfer”, however, the draft decree redefines much of what was intended as a doubling by the German legislature into a transfer with the resulting pricing and documentation obligations.

The draft decree also increases the general recordkeeping and documentation obligations by specifying that, in addition to the determinations required by the AStG and the FVerIV, documentation must be provided in regard to the economic background of and advantages created by the function transfer from the perspective of the company group as a whole as well as of the companies directly involved in the transfer¹⁶. This documentation requirement has been criticised as excessive by various business organisations and it is therefore expected that the decree will be amended before entering into force.

2. General Rule Regarding Pricing of Business Functions

The main difference between determining a transfer price for the transfers of a business function abroad and other transfer price determinations is that, if the standard methods for determining arm’s length prices – the comparable uncontrolled price method, the resale-price method and the cost-plus method -- cannot be adequately applied and adjusted for factors such as the corresponding opportunities and risks of the business function, the taxpayer must determine a “package price”¹⁷ by carrying out a “hypothetical arm’s length comparison” which takes into account various additional factors such as the profit expectations of the function.¹⁸

3. Documentation of Function Transfers

Generally, the documentation and recordkeeping requirements in regard to the transfer of business functions abroad are governed by the same provisions applicable to other transfer pricing determinations.¹⁹ Additionally, however, if no standard arm’s length method is applicable, documentation must be provided to support the determination of a hypothetical transfer price and to prove the appropriateness of the transfer price so determined. In such case, documentation must include not only a calculation of

¹⁶ Sec. 3.1 of the Draft Decree.

¹⁷ Sec. 3.1 of the Draft Decree.

¹⁸ Sec. 3 (2) GAufZV.

¹⁹ See, for example, Sec. 90 (3) AO.

the profit potential and an appropriate price range but may also require the provision of evidence supporting a specific price within that range.

Generally, therefore, the following main types of documentation must be created in regard to transfers of business functions abroad:

- information regarding all relevant facts, particularly the impact of the function transfer on the operative structure of the affiliated group and the employee structure including all contracts which are relevant to the transfer;²⁰
- documentation supporting the appropriateness of the price for the business function from the perspective of all involved parties based on profit expectations including, in particular, information as to the calculations and expectations on which the decision to carry out the function transfer were based which show the actual reasoning behind the decision to transfer the function;²¹
- documentation regarding long-term service or delivery arrangements including all relevant contracts; and
- information as to the taxpayer's research and development activities within the 3-year period prior to the function transfer but only if the taxpayer regularly conducts research and development activities and already keeps records regarding such activities for internal purposes.

Since the transfer of a business function is generally considered to be an extraordinary business transaction, the increased documentation obligations set forth in Section B(2) above regarding the timing of preparation and the provision upon request of the tax authorities will also be applicable to such transfers.

For more information as to the determination of prices regarding transfers of business functions abroad, please see the following articles which are included in these conference materials:

Peter H. Dehnen and Rosemarie Rhines, Germany's New Transfer Pricing Rules on Transfers of Business Functions Abroad, IBFD Bulletin, November 2008

Peter H. Dehnen, Sabine Junghans and Rosemarie Rhines, Draft Ministry of Finance Decree on the Transfer of Business Functions Abroad, IBFD Bulletin, November/December 2008

²⁰ Sec. 4 GAufzV.

²¹ Sec. 2.2.1.2, 2.3.2.1, 2.3.2.2 Draft Decree.

D. Consequences of Insufficient or Incorrect Supporting Data

A taxpayer who fails to comply with the duty of cooperation in regard to transfer price determinations – for example, by not disclosing transfer pricing records, disclosing unusable information or not providing documents within the appropriate time -- could be subjected to sanctions.

Furthermore, such non-compliance generally creates a rebuttable presumption that the taxpayer's income in regard to which insufficient evidence was provided is higher than the income declared to the tax authorities²² and the tax authorities are entitled to adjust the reported income accordingly²³ by exhausting any available price ranges to the disadvantage of the taxpayer.

The tax authorities may also assess penalties of 5-10% of the additional income so determined (minimum of EUR 5,000) if documentation is not disclosed or the disclosed records contain unusable information. A taxpayer who discloses usable records but not within the required time period can be charged a penalty of up to EUR 1,000,000 (minimum of EUR 100) for each complete day of delay.²⁴

Finally, Germany's significant departure from the OECD guidelines for determining prices for business function transfers may result in double taxation since the country in which the transferee is located will likely apply different rules and may not completely provide relief for taxes paid in Germany.

E. Summary

Taxpayers conducting business in Germany must be prepared to meet all transfer pricing documentation obligations, particularly those regarding the determination of prices for transfers of business functions abroad. Since this includes observing the provisions of all applicable decrees issued by the Ministry of Finance in regard to transfer pricing, the documentation and recordkeeping burden has become extremely onerous over the past few years and this trend can be expected to continue for the foreseeable future.

²² Sec. 162 (3) AO.

²³ Sec. 162 (1) AO.

²⁴ Sec. 162 (4) AO.