

Advance pricing agreements in Germany

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The most important effect of an APA is the creation of a trusting relationship between taxpayers and tax authorities

Since the first draft guidelines in 2000, the German government has been working on Advance Pricing Agreements (APA) guidance for many years. After the April 2005 Administrative Principles on transfer pricing documentation, on October 5, 2006 Germany's Federal Ministry of Finance released a long-awaited circular for bilateral and multilateral advance pricing agreements ("APA circular").¹ This circular on APAs provides extensive guidance on how taxpayers may apply for, negotiate, and obtain an advance accord in Germany. In addition, an appendix of the "Draft Advance Pricing Agreement" is attached to the APA circular.

I. Background

A. Legal basis

In Germany, there is no specific legal basis for APAs. Unlike many other countries, where an APA is governed by a contract between the taxpayer and the competent authority, the German competent authority is not permitted to conclude a tax agreement with taxpayers under German tax law. To generate and execute APAs in Germany, the authority must resort to the Article 25 of the OECD Model Tax Convention and the corresponding mutual agreement article of the double taxation treaties, as well as the OECD Transfer Pricing Guidelines, especially its annex "Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure" ("MAP APA").

Article 25 provides the German competent authority with the ability to conclude an "advance agreement

procedure" with the other competent authorities upon the application of the taxpayer. Such an agreement is legally binding in Germany, which means it should be implemented. This is done by a "binding advance ruling" to the taxpayer.²

Reflecting this legal specification, German APAs can be divided into two parts:

- An advance agreement between the German competent authority and one or more related foreign competent authorities, and
- A binding advance ruling between the taxpayer and the in-charge local tax office.

The APA process focuses on identifying an appropriate transfer pricing method, not a desired tax result. An APA is built around the arm's length principle.

B. Unilateral APAs vs. bilateral and multilateral

If only one jurisdiction is involved, the agreement is unilateral. In Germany, unilateral APAs are offered in the form of a binding ruling according to Section 204 of the Tax Procedure Act ("AO")³ or information provisions in accordance with Section 89 Para. 2 of the AO. Because unilateral APAs have no binding effect on the other country concerned and may not help to overcome the legal uncertainty the taxpayer faces through transfer pricing, for example double taxation, the Federal Ministry of Finance is typically not prepared to grant unilateral APAs in transfer pricing issues. Therefore, the German tax authorities are instructed to only grant APAs on a bilateral or multilateral basis.

Where a German taxpayer has concluded a unilateral APA with a foreign tax authority, German tax authorities will not regard themselves bound to such a

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foreign unilateral agreement. If the taxpayer requests that the German tax authorities consent to the unilateral APA, the authorities will only do so if it is not problematic in their eyes. However, a rejection of such an application often leads to the taxpayer being subjected to even more intense audit scrutiny in Germany.⁴

Complex business transactions mostly involve group companies in several countries, and so they necessitate multilateral APAs between more than two countries. Such multilateral APAs are very difficult to achieve, primarily due to practical concerns. Competent authorities cannot meet for only one taxpayer, except in extraordinary cases, possibly during OECD meetings; therefore meetings between two competent authorities treat multiple cases, and from a practical standpoint it is almost impossible to organise multilateral meetings for multiple taxpayers. In multilateral cases, it is advisable to organise a bilateral APA procedure plus a series of unilateral APAs with multiple countries, but informing all tax authorities about the achievements in the other countries. Such a series of unilateral APAs were very successful in practice, for example in the pharmaceutical industry or in the high-tech area.

There are also many recent unilateral APAs in several German states such as Bavaria in respect of foreign countries such as Austria.

II. Features of the German APA process

A. Federal central tax office vs. local tax offices

Within the Federal Ministry of Finance, oversight for APA applications and for granting an APA has been centralised in one department, located within the Federal Central Tax Office in Bonn. The Federal Central Tax Office acts as the competent authority in mutual agreement procedures in Germany.

In addition to the Federal Central Tax Office, the local tax office is also regularly involved in APA procedures as well. The Federal Central Tax Office will not approve any APA application or settlement negotiated with another competent authority if the tax authorities of the respective federal state or local tax office oppose the agreement. The talks between the Federal Central Tax Office and the representatives of the states and local tax offices may require more time than the talks with the competent authorities of other countries. In Germany, the average duration of the APA process could range anywhere between one to three years. Some cases require more time.

B. Pre-filing meeting

Since filing an APA is normally costly, the taxpayer may request a pre-filing meeting before applying for-

mally for an APA (Para. 2.2 of the APA circular). This meeting can be on either an anonymous or named basis.

The main purpose of pre-filing is to discuss the proposed APA and its overall procedure with APA programme personnel prior to committing to the process, and to assess its potential strengths and weaknesses. Pre-filing clarifies whether an APA would be appropriate, what types of information would be necessary to support the request, and whether the proposed transfer pricing method would be appropriate. However, the pre-filing meeting does not allow the taxpayer to receive binding substantive law comments. At this early stage, the foreign competent authorities should also be involved.

Anonymous pre-filing meetings do not make very much sense, because the German tax authorities are not willing to give more than very simple answers in such meetings. A short phone call between the adviser and the competent authority often proves to be more efficient in these cases.

Pre-filing meetings on a named basis are very helpful in practice.

C. Information required for APA applications

Unlike some countries with a qualitative or quantitative threshold for applications, Germany does not limit APA applications to situations involving complex transfer pricing arrangements or legal uncertainty regarding the taxpayer's related party transactions.

A written application should be submitted directly to the Federal Central Tax Office or through the regional tax office. The taxpayer can limit the APA application to certain transactions or to transactions with certain related parties based in certain countries, for instance. In terms of the content of the APA application, the German APA circular largely goes along with the international and OECD standards. As set forth in Paras. 3.4 and 3.5 of the APA circular, the application should include the following information and documents:

1. A description of the transfer pricing method to be used in the agreement, and a justification of why it is the most rational method in the context of the arm's length principle.
2. Documents and a detailed template of calculation of transfer prices.
3. Unrelated party data (e.g., prices, gross margins, costs plus), including details of future adjustment calculations.
4. Shareholding structure of the group.
5. Organisational and operating structure of the group.
6. Business areas as relevant for the APA.
7. Business relationship between the related parties.
8. Functional and risk analysis.
9. A description of the main assets employed.

10. Market and competitive conditions as well as business strategy.
11. A description of the value chains and contributions of the related parties involved.
12. A list of all open tax issues.

The time when the Federal Central Tax Office receives the application is relevant for the earliest possible start date of the APA (Para. 3.1 of the APA circular), which is ordinarily determined to be the beginning of the fiscal year in which the application has been submitted. The taxpayers can withdraw their application with the effect that the basis for the APA does not exist anymore (Para. 7.2 of the APA circular). However, this option should be used only with utmost care.

D. Critical assumption

Critical assumptions are a crucial part of an APA. A critical assumption is an objective business and economic criterion that forms the basis of a taxpayer's proposed transfer pricing method. It is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed transfer pricing method.

Critical assumptions may fall into operational, legal, tax, financial, accounting, and economic categories. Each of these categories comprises several aspects, which should be discussed among the parties and addressed in the written contract of the APA. Para. 3.7 of the German APA lists several main critical assumptions that should be taken into account when drafting an APA:

1. Corporate shareholding structure.
2. Constant conditions regarding market conditions, market shares, revenue volumes, and sales prices (e.g. no significant changes due to new technology).
3. Constant conditions regarding regulatory law, customs, import and export restrictions, and international payment transactions.
4. Constant function and risk allocation and capital structure.
5. Constant business model.
6. Constant conditions regarding exchange rates and interest rates.
7. Taxation in accordance with the APA in other state.
8. No material changes in the tax framework of the other state.
9. Transfer pricing adjustments of the state not being involved in the APA.

APAs are shaped around these critical assumptions, which then become part of the contractual agreement. For any deviation of the critical assumptions, the taxpayers involved in the APA are obliged to inform the responsible tax authorities. If the taxpayer fails to meet a critical assumption, the APA may become inappropriate or unworkable. Legally speaking, if this is

the case the APA must be renegotiated or, failing that, terminated. A decision on modification or termination of an existing APA will be made only after a discussion with both the taxpayer and the foreign tax authorities.

E. APA documentation

The taxpayer must document and confirm that the conditions agreed to under the APA have been met and that there is no change of the critical assumptions (Para. 6.1 of the APA circular). Furthermore, it should be co-ordinated with the tax authorities whether and to what extent other legal documentation requirements (e.g. according to the Regulations on Documentation of Income Allocation – "GAufzV"⁵) should be met at the same time as the APA documentation.

The APA documentation must be submitted to the Federal Central Tax Office annually and should be attached to the respective tax returns. After the submission of the documentation, an independent audit of compliance with the conditions will be conducted within the framework of a tax audit.

F. Terms of an APA and availability of rollback

The German APA circular gives some flexibility as to the term and duration of an APA. The optimal length of an APA is expected to be between three and five years. A rollback to past periods is allowed if the factual circumstance of the previous fiscal years corresponds with the APA period (Para. 7.3 of the APA circular). Although strictly seen, the rollback application is a separate mutual agreement procedure and the conclusion of such a rollback agreement is handled through the same administrative and negotiation process.

With respect to small and mid-sized enterprises as defined in Article 6 of the GAufzV, though the procedural process is similar, the circular still provides some simplifications (Para. 8 of the APA circular). This can be seen in that the Federal Central Tax Office is authorised to alleviate documentation and jurisdiction obligations for the applicant taxpayer in terms of information and documentation to be submitted and third party data to be analysed.

G. Cost of APA

According to Article 178a Para. 2 of the AO, the basic fee for each application amounts to €20,000. This basic fee is due even if an APA will not be issued as set out in the application process. In the case of multilateral APAs, the fee will be incurred for each country involved.

In addition, the extension of an existing APA costs €15,000 ("extension fee"). To amend an existing APA, the proposed amendment fee is €10,000. The fee is payable on receipt of the APA application by the Federal Central Tax Office and is due immediately. With

respect to small enterprises as defined in Article 6 of the GAufzV, the fee is halved according to Article 178a Para. 3 of the AO.

III. Recommendations

A. What business circumstances make an APA worthwhile?

An APA provides the taxpayer with legal certainty on what transfer pricing method will be accepted by the involved jurisdictions. However, an APA is not set to determine *ex ante* any level of taxable profit *per se*. Rather, it is a legally enforceable agreement on transfer pricing methods and critical assumptions, which normally covers selected transactions (or business activities) for specified years and affiliates of the multinational company. From the taxpayer's point of view, an APA is worth achieving under the following circumstances:

- Affiliated parties are densely integrated in the relevant business in such a way that a prudent businessman cannot assign functions and risk unambiguously to either entity.
 - The relative value of intangibles contributes significantly to the business value.
 - Comparables do not exist for the taxpayer's type of business.
 - The taxpayer seeks legal certainty for strategic business decisions.
 - An APA will not disproportionately limit the taxpayer's future flexibility on strategic business decisions.
- Other facts and circumstances that make an APA worth taking into consideration should be conceived in accordance with the given case. In general, the taxpayer should consider an APA as a strategic tool to deal with transfer pricing issues. Whenever there is a business reorganisation and/or revision of the multinational's transfer pricing system, APAs for complex issues should be put on the table. From the tax authority's point of view, the introduction of an APA programme may reduce legal uncertainty in the field of taxation. Consequently, it will set incentives for foreign direct investments.⁶

We have worked on practical cases that included APAs for:

- A big pharmaceutical group, which changed its business model and transferred several functions to other countries;
- A complex high-tech group with a very linked and complex cross-border business model between three countries. We used the RPSM, resulting in huge balancing payments between the countries;
- An electronic equipment manufacturer that changed its supply chains and network;
- A well-known consumer company that changed its business model from resale price method to the overall profit split method and transferred functions abroad.

B. The role of APAs in the economic downturn

Depending on the facts and circumstances in a particular taxpayer's case, the APA programme generally does not consider an economic downturn as a violation of a critical assumption. On the other hand, APAs could be especially beneficial in an economic downturn because they make it possible to discuss the effects of the recession on transfer pricing with tax authorities in real time.

For instance, the APA programme provides the taxpayer with the option of negotiating profit tests with wider single-year or non-traditional adjustments to the tested party and comparable companies, as well as including a critical assumption in the APA that reflects economic circumstances.

IV. German APA statistics

Since the issuance of the APA circular in 2006 in Germany, the APA has been an even more popular instrument of gaining certainty about transfer pricing arrangements in advance. By the end of 2008, Germany had total of nine APAs in force, and five of which are with EU Member States.⁷ Four APAs were granted in 2008. Moreover, the Federal Central Tax Office received 20 to 25 APA requests in 2009. So far there are more than 100 requests in various stages of the process, Ministry officials said. The newest requests are mostly from taxpayers with affiliates in the Unities States, followed by European countries, primarily France. So far, no APA request has been rejected. Top treaty partners that have concluded bilateral APAs with Germany are the United States, Japan, France and the United Kingdom.

V. Conclusion

APAs are increasingly necessary for gaining security in complex situations, particularly when business models are revised and when functions, risk, and intellectual property are relocated to other countries. APAs have proven very helpful in cases of unexpected events like the economic downturn.

The most important effect of an APA is the creation of fairness and a trusting relationship between taxpayers and tax authorities. Since the prevailing economic structures of today have made it impossible to take each possible change into account in the APA programme, an APA can therefore only be successful if all parties are willing to act in the spirit of the agreement.

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¹ BMF 5.10.2006, BS tBl. I 2006, 594.

² Engler, G and Elbert, D, Chapter F: Procedures, in Voegelé, A./ Borstell, T./Engler, G.: *Handbuch der Verrechnungspreise*, 3rd version, Beck Munich, 2010

³ Abgabenordnung

⁴ Schnorberger, Stephan "Germany's New APA Circular: Practical Guidance, Clarification", *BNA Tax Management Transfer Pricing Report*, Volume 15 Number 14, November 22, 2006.

⁵ Verordnung zu Art, Inhalt und Umfang von Aufzeichnungen im Sinne des § 90 Abs. 3 der Abgabenordnung (Gewinnabgrenzungsaufzeichnungsverordnung – GauzV) of 13 November 2003.

⁶ Voegelé/Vögele: Advance Pricing Agreements bzw. Verbindliche Auskünfte im Rahmen der neuen deutschen Verwaltungsgrundsätze, NWB Steuer und Studium, 2002

⁷ EU Joint Transfer Pricing Forum Draft 2009 APA table, (http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm).