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Germany

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Issue One

Please indicate if the profit split method is provided for in your country legislation and, if so whether your country legislation provides guidance on its application. Please elaborate on the domestic guidance on this issue which goes beyond the guidance contained in Chapter II of the OECD TPG.
In case your country legislation does not provide for the use of the profit split method, please explain whether it is actually used in practice by taxpayers and its acceptability by tax administrations.

German transfer pricing guidelines do allow for the application of the profit split method in certain situations. In this context, the most important guidelines are the "Verwaltungsgrundsãtze 1983"[1] from 1983, and the "Verwaltungsgrundsätze Verfahren"[2] from 2005.

The 1983 guidelines are relatively dated and place a stronger emphasis on standard methods, but do allow for profit splits[3] in principle. Although they do not provide more guidance than that the attribution of profits should be "appropriate" and "as agreed between prudent managers."

The newer German guidelines follow the OECD Guidelines quite closely, and therefore allow for the application of the methods described by the OECD. However, the German guidelines still formally refer to the OECD Guidelines as of 1995, so traditional methods are still regarded as preferable (hierarchy of methods). However, in practice German tax auditors do accept the 2010 OECD Guidelines, so no strict hierarchy of methods is always required. Moreover, even the German guidelines explicitly demand the use of profit split methods if several Entrepreneur entities contribute to a business and the contributions cannot be separated differently[4]. The guidelines explicitly mention global trading as a business field that might be tested by profit splits.

The German transfer pricing guidelines lean towards the residual profit split methodology, as they principally distinguish between "Routine" and "Entrepreneur" companies. Even before transfer pricing methods are discussed in detail, it is established that the "Routine" companies should earn low but stable profits[5], while the Entrepreneurs should receive the residual[6]. Additionally, the newest transfer pricing guidelines for permanent establishments state that the residual profit split should be used for global trading activities.[7]

One limitation of the German transfer pricing guidelines is that they do not accept the "comparable profit split method," as the method does not lead to arm's length results and is not a transactional method.[8]

The German Ministry of Finance is currently working on a new decree on the application of the arm's length standard, which will focus on transfer pricing methods. No official draft has been released yet, but it has been hinted that the profit split method will probably be strengthened when the decree is published, likely in 2016.

Profit splits are used extensively in Germany, as many German companies are strongly intertwined in multinational supply chains, where several participants contribute significant intangibles. More specifically, German groups can be heavily focused on product and production know-how, while operating in the German market often gives rise to a German-specific brand for many distribution companies.

Due to this extensive use and formal acceptance of the method, profit splits are generally accepted by German tax authorities—if they are appropriately applied. German tax auditors usually have a strong understanding of profit splits and investigate their use in detail.

Issue Two

Based on your practical experience in your local tax jurisdiction, please elaborate in what scenarios/structures/circumstances the profit split method is found to be the most appropriate method. Please also provide information on the instances in which the profit split method is most commonly used (e.g., application by taxpayer, audit, APA, dispute resolution).

In practice, profit split methods have become standard in many cases, and form the majority of the cases the authors work on. Profit split methods are typically applied to interdependent and strongly integrated structures whenever more than one entity contributes non-routine services or valuable assets.

Today, many if not most companies with cross-border transactions have integrated value chains, where more than one company contributes entrepreneurial intangibles or non-routine functions. In these cases, it is practically impossible to identify truly comparable firms or transactions, especially as "in house" transactions within the groups often systemically differ to transactions with or between third parties.

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Here are some examples of transactions where profit split systems are typically used (depending on the exact circumstances of the case):

- License fees / royalties for intangibles (unilateral PS).
- Global trading and other interdependent financing.
- High-tech goods with R&D and marketing contributions by various parties that are interdependent and should not be valued on a standalone basis.
- Situations where the benefits of a unique commercial transaction would arise and would need to be appropriated according to the bargaining power of the parties.

In Germany, profit splits are frequently used by taxpayers and tax authorities alike, and can be used in all contexts, from planning to APAs, documentation, planning, and dispute resolution.

Small and mid-sized companies in particular occasionally use profit splits to set their transfer prices, although they do not always document this process sufficiently, and sometimes translate the results into a cost-plus margin for everyday purposes. Nevertheless, since the latest substance-over-form decisions[9] in Germany, such systems should also formally be defended and documented via the profit split method.

Issue Three

Based on your practical experience in your local tax jurisdiction, what information can be useful in determining the arm's length allocation among the entities of a group of the (residual) profit under the profit split method (e.g., information prepared for tax and non-tax purposes; information from third-party cooperative arrangements, such as joint ventures). What are the practical obstacles to obtain and/or use such information in the transfer pricing analysis?

A well-structured profit split system is often the most appropriate transfer pricing solution for multinational companies to illustrate the complex contributions of each party along the value chain. A profit split is appropriate and accepted by German tax authorities in circumstances where all entities perform non-routine functions, assume non-routine risks, and own valuable intellectual property that is used in intercompany transactions. German tax authorities require careful examination of the intercompany transactions under review, especially in profit splits.

Where a residual profit split is applied, the remuneration of routine functions needs to be determined. The residual profit split divides the total profit in the controlled transaction into two stages. In the first stage, each participant is allocated sufficient profit for a routine return appropriate to its functions. The remuneration for routine functions typically can be benchmarked using third-party information. German tax authorities accept various databases that provide third-party information. In the second stage, any residual profit (or loss) is allocated based on an analysis of the facts and circumstances that might indicate how this residual would be divided between independent enterprises.

The profit base in a profit split requires the analysis of the profits that result from an intercompany transaction. For example, it might be the case that one entity provides intangibles only for certain products. In such a case the profits achieved with these products need to be examined and separated from profits from other sources. This can be problematic.

For profit splits that use capitalized contributions, the economic profit needs to be determined. The economic profit recognizes the entities' investments by determining the allocation key of the profit split. The investments are deducted after the allocation of the economic profit between the entities to arrive at the final profit. Such a profit split may quickly become a complex analytical exercise, especially when combined with a residual analysis and when more than two parties are involved in the profit split. German tax authorities have accepted such models in the past.

The profit split methodology attributes a share of the overall operating profit from an intercompany transaction to affiliated entities based on an allocation key, which reflects the contribution of each participant to the total value chain. The functional analysis and the determination of the allocation key are necessary in any profit split analysis and are examined in detail by German tax authorities. The allocation key can be based on various factors representing the significant profit drivers in a transaction.

Capital-based allocation key: German tax authorities generally accept the use of capital-based allocation factors in appropriate cases. A capital-based allocation key can be used if the capital appropriately reflects the contribution of the respective parties to the overall value creation.

The capital included in this kind of contribution analysis can comprise a mix of physical assets and intangible assets created by the entities. The physical capital can be gathered from the balance sheets. The profit split, however, needs to appropriately reflect the intangibles created by routine and non-routine functions of the personnel. These intangibles are usually not included on balance sheets in Germany.

German tax authorities require the analysis of intangibles in capital-based profit splits. The investments for non-routine functions can be capitalized applying useful lifetimes, gestation lags, and the mid-year convention of investments. The non-routine investments can consist of payments for R&D, marketing, or other operational expenditures. Restructuring costs may also be considered an investment for the continuation of the operating business, and as such may be included in the profit split.

Furthermore, personnel costs for routine and non-routine functions can be capitalized. The personnel contribute to the creation of intangible capital, such as production know-how, customer relations, or local brand images. Non-routine personnel typically create intangibles that are useful for a certain time span, e.g., sales staff develop customer relationships that can be used for some years. Also routine personnel create intangibles such as know-how or workflows; however, these intangibles are usually limited in their useful lifetime.

Capital contributions of each entity in the profit split are calculated by capitalizing the various investments in significant and non-significant intangibles. The allocation keys can be determined by the share of capital each entity contributes to the total capital in a transaction. The related party profit (loss) split allocation factors analyzed in a capital-based profit split can be used to allocate income to each entity based on its respective capital contributions. Such an allocation mechanism is arm's length since it remunerates each entity for its investments in intellectual capital and physical assets. German tax authorities have accepted capital-based profits splits in the past if the capital contributions had been well documented. The overall business risk is shared between all entities and as such is a fair arm's length system that independent third parties would agree upon under comparable circumstances.

Expert surveys as allocation key: German tax authorities accept expert surveys for the analysis of allocation keys. Expert surveys are an important tool often used for calculating the value of intangible assets in a wide range of cases, including product liability, royalties for intellectual property, and antitrust. An important aspect of conducting an expert survey is the selection of the experts that are interviewed and the request for their best estimate. The admissibility of expert survey results depends on various elements such as:

- the **qualifications** of the survey experts;
- the **helpfulness** of the testimony to the facts; and
- the **reliability** and fitness of the testimony.

The survey process needs to be documented in detail, ensuring an objective and unbiased expert testimony.

Expert surveys can be used to assess the contributions of two or more entities in a given transaction to the economic benefit of the transaction. German tax authorities have high standards for the use of expert surveys since they are not commonly used and have been applied only quite recently.

Business indicators as allocation key: If the entities contributing to a transaction use business indicators internally to measure the performance and contribution of each entity, then these business indicators can be used as an allocation key for splitting the profits of the transaction. Using such a non-tax-related business indicator has the advantage that it clearly adheres to the arm's length principle since it shows the key economic variables in a given transaction that independent third parties would use to split their profits in a joint venture-based scenario. German legislation prescribes that intercompany transactions should be priced from the perspective of a double prudent and conscientious manager ("doppelter ordentlicher und gewissenhafter Geschäftsführer"), applying economic reasoning to any intercompany transaction. The use of non-tax-related indicators can and should comply with this rational.

Game theory as allocation key: Game and contract theory can be used to analyze arm's length allocation factors. The German legislation prescribes that intercompany transactions should be priced from the perspective of a double prudent and conscientious manager, simulating the bargaining power of each entity involved in the transactions. For example, the Shapley value method can be used to simulate the bargaining power of entities along a value chain contributing different functions. Independent companies forming a joint venture would always assess their contributions to the business and negotiate over their profit shares based on their relative bargaining power.

The authors have used the described methodologies in many cases. All allocation keys have been accepted in practice.

Issue Four

Based on your practical experience in your local tax jurisdiction, please indicate which are the key limitations and/or practical difficulties encountered in applying the profit split method (e.g., new business models/operating structures, access to information, computation of profits, identification of appropriate allocation keys), and how could these be overcome or minimized.

Profit splits require careful calculation of the allocation keys. Gathering the relevant information from clients can be problematic.

The financial statements of the analyzed entities are sometimes organised using different accounting procedures, depreciation rates etc. Establishing a basis for comparing the capital of various entities can be challenging. In capital-based profit splits, physical assets such as inventories and receivables should be included. Analysis must be conducted as to whether the year-end values reflect the actual capital employed by comparison with the average values during the year.

When personnel costs are used as allocation keys, the costs incurred for various functions need to be determined. In some cases this requires gathering financial information for all cost centres and qualifying in close collaboration whether the costs incurred for each cost centre are incurred for a routine or non-routine function. Collecting this data may require substantial amounts of time.

Profit splits can also be used for all transfer pricing-related situations in Germany: planning, documentation, and audits.

Planning: Profit splits can be used to set prices for intercompany transaction from an ex-ante point of view.

Often an issue arises when the financial results at the end of the fiscal year require adjustments. If entities need to adjust their profits in accordance with the results of the profit split, they have to adjust their prices from an ex-post point of view, which can be problematic in some circumstances. Any retroactive adjustment requires agreements which are determined ex ante. Also, custom duties problems can arise if prices need to be changed ex-post for a whole year.

As a practical solution to the problems arising from ex-post changes of product prices, the prices can be reassessed throughout the year and be changed for the remaining part of the fiscal year. If, for example, the intercompany prices are established based on a profit split and applied to the budgeted profits of two entities at the beginning of the fiscal year, the prices can be reassessed monthly or quarterly. If they earned more or less than was determined by the profit split, the intercompany prices can be adjusted for the remaining part of the fiscal year. In this way the allocation of profits as determined by the profit split could

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be reached from an ex-post point of view without the problems described above.

Such a system requires a department that is capable of changing prices continuously throughout the year. NERA has experienced that this is possible even for companies active in the retail markets that sell thousands of different products. Such systems are generally accepted by German tax authorities.

Documentation/audit: Profit splits can be used in transfer pricing documentation to justify the profit allocation from an ex-post point of view. German transfer pricing legislation states that taxpayers can use any transfer pricing method to test the arm's length principle for intercompany transactions from an ex-post of view, independently from the transfer pricing method used to determine the transfer prices from an ex-ante point of view.[10]

The OECD principle "Substance over Form" applies to Germany as well[11]. A formal requirement, however, is that the relevant tax treaties contain corresponding clauses such as the OECD Model Treaty[12]. It is our understanding that the profit split can be justified expost when prices in companies have been set by the management in a way that reflects the double prudent and conscientious manager. In such cases, the group entities typically negotiate prices based on business-related profits.

The authors use profit split methods regularly. German field tax auditors have accepted these methodologies in all cases.

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NOTES

[1] ,,Grundsätze für die Prüfung der Einkunftsabgrenzung bei international verbundenen Unternehmen (Verwaltungsgrundsätze)", February 23, 1983

[2] ,,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)", April 12, 2005

[3] Verwaltungsgrundsätze 1983 2.4.6

[4] Verwaltungsgrundsätze-Verfahren 3.4.10.3 c)

[5] Verwaltungsgrundsätze-Verfahren 3.4.10.2 a)

[6] Verwaltungsgrundsätze-Verfahren 3.4.10.2 b)

[7] ,,Verordnung zur Anwendung des Fremdvergleichsgrundsatzes auf Betriebsstätten nach § 1 Absatz 5 des Auszensteuergesetzes (Betriebsstättengewinnaufteilungsverordnung - BsGaV)" August 28, 2014, § 22 (3)

[8] Verwaltungsgrundsätze-Verfahren 3.4.10.3 d)

[9] Cf. *Bloomberg BNA Transfer Pricing Forum*, Volume 15, Number 1, Germany by the authors, January 2014.

[10] Verwaltungsgrundsätze-Verfahren 3.4.12.1

[11] C.f. BFH as of 11 October 2012 ■ Az. I R 75/11

[12] C.f. for this a description of the circumstances: Voegele/ Alexander, de Homont/ Philip, Germany, Transfer Pricing International Journal, Volume 15, No. 1, January 2014.