1. To what extent are a multinational enterprise's intra-group contracts respected for transfer pricing purposes?

Intra-group contracts are the starting point of transfer pricing analysis and are—generally—respected in Germany. However, German tax auditors have a long tradition of scrutinizing the actual conduct of the parties, and they have various instruments that allow for a reclassification of transactions from their original contractual form.

In Germany, transfer pricing corrections are typically conducted as an income correction, through one of the following:

- A profit “withdrawal,” or capital contribution
- A deemed dividend distribution, or contribution
- An income correction based on the Foreign Tax Code

German authorities can effectively overwrite existing intra-group contracts if they are in contradiction to transfer pricing regulations. Authorities generally follow the arm’s-length principle (although at many points with a specific German interpretation). The German Federal Ministry of Finance has issued a number of decrees, which specify the application of the law. In practice, these decrees establish the transfer pricing norms, including situations in which intra-group transactions can be classified differently from their contractual form.

The legislative regulations are:

- Documentation of Profit Allocation (GAufzV),
- Directive on the Relocation of Functions (FVerlV), and
- Directive on Allocation of Profits to Permanent Establishment (BsGaV).

Additionally, the following guidelines are binding for tax authorities, but not for taxpayers or tax courts. In practice, these guidelines still establish standards that are followed:

- Administrative Guidelines,
- Administrative Guidelines for Permanent Establishments,
- Administrative Guidelines for Cost Allocations,
- Administrative Guidelines for Secondment of Personnel,
- Administrative Guidelines for Procedures, and
- Administrative Guidelines for Relocation of Functions.

Furthermore, “administrative statements” can be relevant for adjustments of transfer prices.

In practice, decisions by the highest tax court have become standard-setting. One important landmark decision dates from October 17, 2001. It states that each transfer price adjustment needs to follow a two-step procedural approach. First, it should be examined whether the transaction was remunerated according to the arm’s-length principle. If the transaction fails this test, the tax authorities can establish an arm’s-length price (different from one specified in the contract) in a second step.

2. How much emphasis is placed on related party agreements as part of a taxpayer’s transfer pricing documentation, or as an important source of functional analysis information?

In Germany, the documentation requirements are split into two parts: the “documentation of facts” and the “documentation of appropriateness.”

The documentation of facts includes most of the material underlying the business transactions. This includes all intra-company contracts. A copy of the contracts themselves must be handed in, along with a summary that reflects the effects on revenues and costs, conditions, duration and date of conclusion, as well as inception of the contract. Moreover, the taxpayer has to point out how it plans to react to unforeseeable economic developments. Notably, the Administrative Guidelines from 1983 had specified that expenses can only be deducted at all if there is a clear ex-ante agreement.

The documentation of appropriateness consists of testing the arm’s-length character of the transaction, which is based on a functional analysis. Intra-group contracts can certainly be very helpful in identifying the distribution of risks and functions between the group entities; however, the documentation must be supported by checking the actual conduct of the parties and likely by further assessments of the value chain elements.

3. What content is expected to be found in related party agreements?

Inter-company contracts are generally expected to contain information that shows clear and unambigu-
uous agreement. In practice, that means that the following elements are considered to be mandatory:
- The involved parties,
- Type of transaction provided and responsibilities,
- Compensation arrangement,
- Start of the contract, and
- Duration of the contract

Furthermore, it is strongly recommended that contracts include clauses on:
- The form of payment (currency, interest rates),
- Termination options,
- Rights for information and examination,
- Applied law,
- Subcontracting,
- Taxes, and
- Arbitration.

4. To what extent can taxpayers be held to their related party agreements, even if they are not in line with normal commercial arrangements or economic reality?

In principle, contracts have to be fulfilled as long as they are in place. In practice, there is a difference between a change that a taxpayer wishes to make for the future and a retrospective audit situation.

The highest federal German tax court has confirmed the validity of oral or factual amendments even when they contradict written contracts. This is especially the case if the amendments reflect normal commercial arrangements or economic reality. Factual amendments also become effective for both parties through repeated execution.

The situation can be different in an audit of prior years. If transfer prices set in a written contract are not arm’s-length, to the disadvantage of the German taxpayer, German tax authorities would very likely disregard the contract, or at least some aspects of the contract (notably the price). On the other hand, German tax authorities cannot adjust transfer prices that favoured the German taxpayer. Even in this situation, most German exports and imports flow to and from treaty countries that have mutual agreement procedures. Therefore, in many cases, German tax authorities can find a solution, likely on an arm’s-length basis even if this contradicts the contract terms.

It should be noted that if a contract reflects the economic reality of a taxpayer from an ex-ante perspective when the agreement was signed, the contract remains binding even if there is a loss or another unfavourable situation.

5. Is the situation different for certain transactions? For example, financial ones?

Normally, German taxpayers have the freedom to choose the contractual form for their intracompany agreements. However, for some specific transactions, there are exemptions where written contracts are prescribed by law or regulation:
- Prominently, cost allocation agreements must be made in writing according to the Federal Ministry of Finance, although some practitioners disagree over whether this is necessarily the case. The same is true for pooling agreements.
- Similarly, after-the-fact-adjustments, especially year-end adjustments, are sometimes placed under special scrutiny. According to the guidelines and some court cases, these adjustments should be made in writing before the respective period, and parties should specify the precise criteria for the adjustment. In practice, this has become somewhat less important, as German tax authorities are becoming more comfortable with results that are in line with the arm’s-length principle.
- The mechanism that calculates year-end adjustments needs to be stated in an agreement. The agreement must include a criteria for when adjustments are applied, and this needs to be entered into beforehand.
- Furthermore, written contracts often become necessary when a routine entity incurs losses, especially over a longer period. In these situations, adjustments might need to be made to ensure arm’s-length remuneration.

In practice, related party agreements are often of somewhat limited value. Transfer pricing questions are complex and later involve issues that were not originally foreseen when the agreement was written. Thus, an “ideal” contract that actually covers the full complexities of the underlying transaction is relatively rare. Consequently, there is often a certain gap between contract specifications and economic reality. In particular, the difference between legal and economic/functional ownership in intangibles is often insufficiently accounted for. In the authors’ experience, such contracts often become challenging in tax audits. Much of our work has concerned audits where problematic legacy contracts existed, and where we could defend the transfer pricing even if it was in contradiction to the old contracts.

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NOTES
5 “Grundsätze für die Prüfung der Einkunftssabgrenzung durch Umlageverträge zwischen international verbundenen Unternehmen” December 30, 1999.