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# **Transfer Pricing Forum**

**Transfer Pricing for the International Practitioner**

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# Germany

Alexander Vögele, Philip de Homont, and Georg Dettmann  
NERA Economic Consulting, Frankfurt

## 1. How does your country identify and adjust related-party financing transactions? What is your country's approach to determining whether the debt arising from a related-party financing transaction should be properly characterized as debt?

Debt-to-equity discussions dominated German field tax audits for many years, but lost importance due to the introduction of the new interest deductibility rules. The new law on interest deduction applies only on interest expenses exceeding interest income plus 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA) (Art. 4h of the Income Tax Code and Art. 8a of the Corporate Tax Code). Escape clauses apply, for example, in cases where the debt/equity ratio of the taxpayer is not lower than the group ratio. Therefore, the question on equity infusion is quite unusual these days in Germany.

The question to what extent a loan would have been granted by an unrelated lender leads to the question of interest rates to be applied. Therefore, the comparability of interest rates has to be checked.

Generally speaking, the German field tax auditors will not react if the loan from a foreign company is interest-free, because they are not obliged to audit the transfer prices in favor of the taxpayer.

If no written agreement exists, there must be a distinction between cases where oral agreements or memorandums exist and those where no agreements at all exist. Only the latter cases may lead to the non-deductibility of interest expense in case of loans from countries with which the tax treaty does not reflect the OECD Model Tax Treaty terms.

## 2. What rules or guidance exist in your country to determine the arm's length interest rate for a related-party financing transaction?

Since the 1980s, Germany has had detailed rules on financial transactions.

The Administrative Principles<sup>1</sup> ("Verwaltungsgrundsätze") enacted on 23 February 1983 deal with the determination of interest and of guarantee fees on the basis of the arm's length principle, and are still in force today. Several other rules on the general deduct-

ibility of interest were based on debt-to-equity ratios. They have been replaced by the limitation of interest deductibility (Art. 4h of the Income Tax Code<sup>2</sup> and Art. 8a of the Corporate Tax Code<sup>3</sup>).

German transfer pricing guidelines do not make a general distinction between valuation methods for inbound and outbound finance transactions. However, the formal framework (beyond valuation aspects) can be significantly different between inbound and outbound transactions. On the one hand, the limitation of interest deductibility ("interest barrier"/ "Zinsschranke," Art. 4h of the Income Tax Code and Art. 8a of the Corporate Tax Code) only relates to German taxpayers. Outbound interest payments are formally limited, whereas no restriction is placed on interest payments to Germany.

Also, it should be noted that Article 1 of the German Foreign Tax Act (Auszensteuergesetz) only opens the possibility to correct transfer pricing that has incorrectly led to an underreporting of the German tax base. Strictly speaking, this is not a distinction between inbound and outbound transactions, but it does mean auditors could only make unfavorable adjustments—either by decreasing the interest paid by a German taxpayer, or by increasing the interest paid by a foreign entity.

In practice, tax inspectors use similar methods to assess inbound and outbound transactions, although they more frequently question the substance of foreign financing entities. The main exception is the court ruling by the Lower Tax court of Munster (7 December 2016<sup>4</sup>), which could be considered an attempt by the German tax authorities to challenge the pricing of inbound inter-company loans.<sup>5</sup> Since this decision would typically imply lower interest payments, tax inspectors more frequently try to apply it to cases where the German entity makes the interest payments.

Interestingly, German Controlled Foreign Corporation (CFC) rules<sup>6</sup> mean financial transactions that have no direct relation to a German entity, but are conducted between foreign subsidiaries, can also be scrutinized in Germany. In other words, German transfer pricing rules can have an implication on transactions that are neither inbound nor outbound. This is somewhat more important for financial transactions, since they are more frequently seen as "passive" income according to these rules.

### 3. Besides the determination of whether a transaction's interest rate is at arm's length, what other factors does your country consider in deciding whether the related-party financing is arm's length and acceptable overall? Examples of additional factors may include: contractual terms, functions of the companies involved, characteristics of the companies' financial products or services, economic circumstances, or business strategies.

The German Administrative Principles ("Verwaltungsgrundsätze," para. 4) require taking into account what a third party would have charged for a similar credit on the money or capital market. Each case must consider the following:

1. Credit level and period;
2. Type and purpose of the credit;
3. Security and creditworthiness of the debtor (taking into account special terms, which third parties would also have granted to the debtor entity as a member of a group of companies);
4. The currency of the credit, the exchange risks and chances, and any hedging costs;
5. The refinancing costs of credits passed on; and
6. Other circumstances of the granting of the credit, especially the capital market conditions.

To estimate security and creditworthiness of the debtor, further considerations should be taken into account:

Firstly, liquidity aspects need to be considered. When liquidity is needed, an intercompany loan is not as easy to resell, as a publicly traded bond would be (i.e., it is more difficult to sell a shareholder loan in the open market, when liquidity is needed, than it is to sell a market traded bond). Therefore, this lack of liquidity should be reflected in the interest rate and must be adjusted for.

Secondly, aspects of (structural) subordination need to be considered. In practice, internal loans tend to be subordinated to external creditors (e.g., priority debt), leading to internal debt being substantially disadvantaged. This structural subordination needs to be reflected in the interest rate applied.

Lastly, in cases where the comparable data obtained derives from loans denominated in a different currency, interest rates need to be adjusted for the fact that different interest rates apply to different currencies.

### 4. If it is determined that any part of a related-party transaction should not be characterized as debt, what are the consequences to both the borrower and the related lender?

If any part of a related-party transaction is not characterized as debt, it is re-characterized as equity.

If it is characterized as equity, the interest expenses and the corresponding admin and transaction costs are not tax deductible.

If these costs are, for example, considered to be motivated by the shareholding relationship, the corresponding income of the recipient is deemed to be a hidden dividend distribution.

The taxable income of the borrowing entity would be increased by the respective reclassified interest expense and for the lending entity, additional withholding tax might become due.

### 5. Are there any relevant court cases or tax rulings in your country dealing with the transfer pricing of intercompany financing transactions?

Several court cases tried to determine the arm's length character of interest rates. Of these, the Federal Tax Court decisions taken on 28 February 1990<sup>7</sup> and 19 January 1994<sup>8</sup> were the most important cases. The 1990 court case determined the interest rate by using the spread between the debit and credit rates of banks and tried to develop a system of functional analysis and of a certain "mean." This court decision was superseded by the Organization for Economic Co-operation and Development (OECD) and also by national developments.

Some state tax courts issued remarkable decisions, including, for example, the aforementioned ruling by the Lower Tax court of Munster (7 December 2016).

That being said, many German taxpayers analyze functions and risks, and perform shadow ratings on the basis of Standard & Poors, Moody's, or Fitch, followed by CUPs from Bloomberg, Thomson Reuters, and others.

Federal field tax auditors often do not accept CUPs from banks because banks have other market conditions, functions, and cost structures than finance companies. Therefore, CUPs from banks, as well as bonds, have to be adjusted by taking into account such differences. These adjustments should be done in the documentation of the taxpayer.

Field tax auditors often question the role of finance companies. Can equity be attracted by the functions and risk-taking by the management of the finance company? Or do the operating companies use the finance company as a common vehicle without its own entrepreneurial function? In such cases, field tax auditors will want to apply the external interest rate of the finance company to the final operating company.

Field tax auditors frequently question the right remuneration of guarantees, which often leads to discussions about the distinction between explicit guarantees, implicit guarantees, and the "backing in the group."

In general, such issues can be solved if the case is well prepared in the documentation of the taxpayer.

*Dr. Alexander Voegelé, Philip de Homont, and Georg Dettmann work at NERA Economic Consulting, Frankfurt.*

*They may be contacted at:*

*Alexander.Voegelé@nera.com*

*Philip.De.Homont@nera.com*

*georg.dettmann@nera.com*

*http://www.nera.com*

#### NOTES

<sup>1</sup> Grundsätze für die Prüfung der Einkunftsabgrenzung bei international verbundenen Unternehmen.

<sup>2</sup> § 4h ESTG.

<sup>3</sup> § 8a KStG.

<sup>4</sup> 13 K 4037/13.

<sup>5</sup> It should be noted that the court's decision was admitted to appeal by the German Federal Tax Court (IR 4/17).

<sup>6</sup> Hinzurechnungsbesteuerung, laid out in § 8 of the Auszenseuergesetz.

<sup>7</sup> BStBl. II 1990, pp. 649 et seq.

<sup>8</sup> BStBl. II 1994, pp. 725 et seq.

