Bloomberg Tax

Transfer Pricing Forum

Transfer Pricing for the International Practitioner

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Germany

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1. Briefly describe the transfer pricing documentation and tax return disclosure requirements in your jurisdiction.

A. Background

Germany has a history of comprehensive transfer pricing documentation requirements that go beyond the OECD standard, in particular regarding the level of detail in the economic analysis and back-up information that needs to be provided.

While the level of detail is higher, Germany has adapted its regulations to the OECD guidance, and its transfer pricing regulations follows the general spirit of the OECD, putting a strong emphasis on the description of value creation and economic analysis. The OECD is the reference for international dispute resolutions, and the German tax authorities are active contributors to the OECD transfer pricing developments.

The transfer pricing documents consist of the following reports: Master File, Local File, Country-by-Country Report (if applicable), extraordinary valuation reports (if applicable), and the "documentation of facts."

B. Legal Basis [1]

The documentation requirements in Germany are set out in a number of laws and decrees by the Ministry of Finance, principally the Fiscal Code (a law), the Decree on the Documentation for Transfer Pricing Purposes (a decree that is compulsory for taxpayers), and the Guidelines on Procedural Questions (a decree that is only compulsory for tax authorities but carries a lot of significance for taxpayers, as well).

Article 90 of the Fiscal Code of Germany[2] details the "obligation of participants to cooperate" (*Mitwirkungspflichten*), among various other aspects of taxation, including a higher degree of cooperation for transfer pricing issues. The Fiscal Code also instructed the Ministry of Finance to issue a Decree on Transfer Pricing Documentations,[3] which determines the nature, content, and extent of the required documentation. The Decree was issued in 2003 and has established the German documentation requirements since then.

Following the OECD initiatives, in 2017 Germany implemented the Local File and Master File by modifying/amending existing legislation[4] and the Country-by-Country Reporting by introducing new legislation.[5] The automated information exchange aspect of Country-by-Country Reporting has been implemented, as well.[6,7]

C. Documentation Requirements

The formal differences between the German transfer pricing requirements and the OECD recommendations of Action Item 13 regarding Master File, Local File, and Country-by-Country Report are comparatively small and pose limited practical implications.[8]

However, in some important aspects, the German transfer pricing regulations go beyond the OECD requirements. In addition to an extensive "documentation of appropriateness" of the arm's length character of intercompany transactions (*Angemessenheitsdokumentation*[9]) that is provided in the Local File, German taxpayers must also prepare a comprehensive "documentation of facts" (*Sachverhaltsdokumentaiton*).[10]

Germany is unique in that the documentation of facts is a comprehensive review of virtually all of the taxpayer's information, with a detailed account of contracts, invoices, general ledgers, business activities, and organization of the taxpayer and related parties.[11] The documentation of facts includes information that is sometimes not strictly necessary to test the arm's length nature of transfer prices. Nonetheless, it is important to be compliant and provide this information, as otherwise the tax authorities may hold that the taxpayer is not fulfilling their obligation to cooperate[12] (*Mitwirkungspflichten*), and the burden of proof might be reversed (see issue 5 below).[13]

Specific requirements apply to "extraordinary" transactions, which refer to any change in how transactions are carried out (e.g., restructurings, changes in contracts, changes in business strategies, changes in the supply chain, etc.). Documentation of such transactions must be prepared contemporaneously (i.e., within six months after the financial year in which they occurred).

Moreover, in practice, German auditors are typically very detail-oriented and therefore generally expect the information to be more in depth. This is especially relevant for "extraordinary" transactions, which fall under specific legislation, such as the "relocation of functions" edicts.[14] Due to the broad spectrum, it is sometimes difficult to recognize when an extraordinary business transaction has occurred. This potentially leads to conflicts during tax audits. If an extraordinary transaction is identified, the taxpayer has to document how this affects the German business operations and how this affects the remuneration

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of the German entity. If a relocation of functions occurs, special legislation applies to calculate an exit tax on the future value of all transferred non-routine profits.

German auditors can sometimes request proof that transfer prices were set according to the arm's length standard *ex ante*, i.e., before a financial year, and not just tested *expost* after the fact.

D. Documentation Deadlines

Formally, transfer pricing documentation of ordinary transactions only needs to be produced upon request by a field tax auditor. The following deadlines apply:

- *Transfer pricing documentation* must be submitted within 60 days after the request of the tax authorities.
- *Extraordinary valuation reports* must be prepared no later than six months after the end of the fiscal year in which the extraordinary business transaction occurred and submitted within 30 days after the request of the tax authorities.
- *Country-by-Country Report:* If the German entity is required to file the Country-by-Country Report, it must do so within 12 months after the fiscal year end.

Given the short timeframe to provide the transfer pricing documentation (i.e., 60 days for normal transactions and 30 days for extraordinary events), most taxpayers prepare the documentation well in advance to ensure they have a solid foundation for the audit.

The following chart summarizes the German transfer pricing documentation requirements:

2. In recent years, have the tax authorities changed or modified their audit approach? (e.g., increase in staffing and/or increase in funding with respect to the transfer pricing audit function; use of risk assessment tools or data mining tools to identify audit targets; use of joint or coordinated audits, etc.). If risk assessment tools are used, what factors are typically analyzed?

Even before the latest OECD initiative, nearly all international companies were continuously audited in Germany. Compared to other countries, the audit system has already been much more comprehensive, both in terms of the frequency in which companies are audited, as well as the level of detail with which auditors investigate the issues.

However, resources were increased by tax authorities on all levels; audits are principally conducted by the local tax offices (*Finanzamt*) and are often supported by specialists from the state and/or even federal authorities. In particular, the Federal Central Tax Office (*Bundeszentralamt für Steuern– BzSt*) participates in audits of large companies in order to ensure common standards and prevent indirect tax competition between states. The number of auditors has increased significantly over the last couple of years – there are now around 600 specialist TP auditors at the federal level alone.

Today, tax authorities have access to the Bureau van Dijk database, and they can verify benchmarking analyses provided by taxpayers. The information gathered in the Country-by-Country Reports may be used to assess imbalances in business activities and profits for certain taxpayers. In recent years, auditors have started to conduct more and more joint tax audits with tax authorities in Europe, especially in the Netherlands, Austria, and Italy.

3. Do the tax authorities focus on certain types of transactions? (e.g., intangibles, financing transactions, commodities, etc.).

Various topics are regularly the subject of audits in Germany:

- Intangible Property: using the OECD's approach to identify economic ownership in IP (i.e., DEMPE analysis)

o CUP benchmarks should be prepared carefully. Taxpayers must show that the actual responsibilities and contributions of the tested contract parties are comparable to the selected comparable contracts. If, for example, the licensor conducts marketing activities that go beyond what unrelated third parties negotiate in trademark license contracts, then the contracts are rejected as non-comparable since the entity performs some DEMPE functions.

o The economic benefit for the licensing companies need to be demonstrated in detail (e.g., increase in sales, reduction of costs).

- Relocation of Functions: Any transfer of function is scrutinized in great detail, and it is critical to prepare a comprehensive economic analysis.
- Routine companies, loss situations, and pan-European studies are often scrutinized.
- Financing companies and intercompany interest rates.
- Management Fees: Taxpayers must follow specific steps to document management fees. First, the cost base must be explained in detail (e.g., personnel costs, expenses). Costs in relation to shareholder activities may not be invoiced and should be kept separate. Costs that are directly attributable to entities are allocated directly and, for other costs, the allocation keys need to be described (time sheets of personnel providing the services, headcounts, usage data, etc.). The markups applied to the costs need to be benchmarked. Finally, and most importantly, the benefit of the receiving entity must be analyzed. In this context, two important questions need to be answered:

o What is the commercial benefit (e.g., increase in sales, reduction of costs) the entity received from the management service?

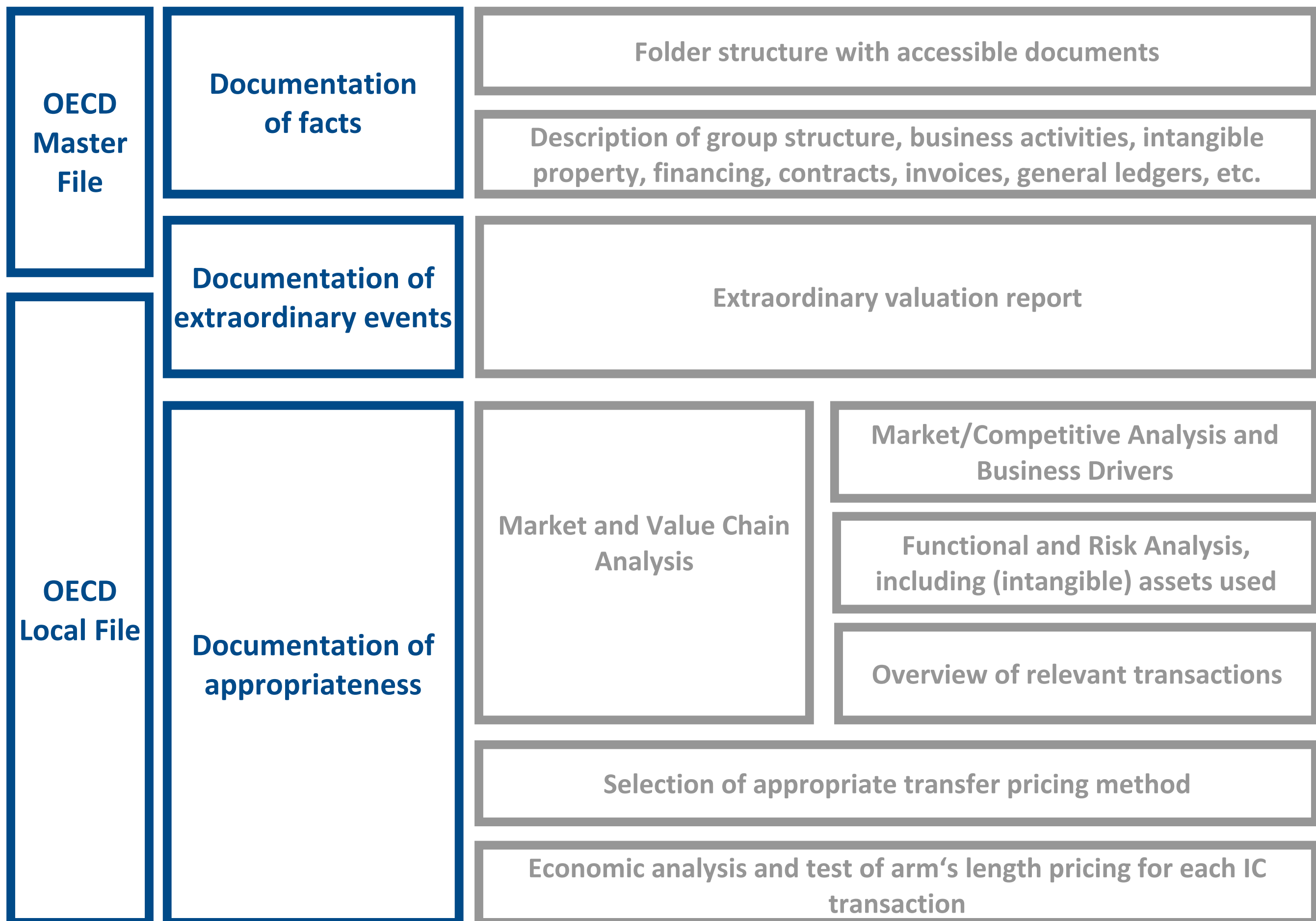
o Would it have been cheaper if the entity had purchased the services from other sources (e.g., external providers of these management services or other types of software, etc.)?

It is important to demonstrate the benefits from centrally providing the management services.

4. Do the tax authorities rely on BEPS-related concepts during its audits? (e.g., DEMPE analysis, new approach for hard-to-value intangibles, expanded use of profit splits, use of risk assessment framework, etc.).

German tax authorities are quickly taking up BEPS-related concepts, often for cases that occurred before the actual release of the BEPS papers. In particular, German tax authorities have strongly embraced the Development, Enhancement, Maintenance, Protection, and Exploitation (DEMPE) concept for the assessment of intangibles.

Today, profit splits are regularly used and applied by German auditors, although TNMM still remains a frequently used method. More than a decade ago, we had to go through significant conceptual discussions with auditors when we introduced the first Profit Split Systems in Germany, whereas today German auditors introduce the use of profit splits and are gen-



erally open to discussing the parameters in depth (where it makes economic sense).

5. Do transfer pricing penalties apply in your jurisdiction? If so, what can be done to mitigate these penalties?

While German documentation requirements are very strict by international standards, direct penalties are relatively low. Although direct penalties exist, the main reason to maintain adequate documentation is that failing to do so could allow the German tax authorities to form aggressive "estimates" of the correct transfer pricing.

The primary sanction for non-compliance is procedural and consists of a rebuttable presumption that the taxpayer's transfer prices were not at arm's length, resulting in an understatement of German income (or overstatement of loss). Such a presumption can be raised against the taxpayer if:

- the taxpayer fails to produce the required documentation;
- the taxpayer produces documentation in a timely fashion, but it is inadequate ("substantially useless");

German tax auditors frequently argue that they would consider documentation to be "substantially useless" in this sense, which effectively reverses the burden of proof. In this case, the tax authorities can form an estimate of the income. They may select the least favorable acceptable value for any assumption in determining the adjustment – while other countries often make adjustments to the median of the comparable data – implying almost certain double taxation (unless otherwise resolved). The reversal of the burden of proof also implies a worse negotiating position in any subsequent litigation procedure.

In addition, the legislation also creates monetary penalties for the failure to produce documentation or producing substantially useless documentation. The penalty is fixed at a range between five percent and 10 percent of the amount of any income adjustment resulting in such situations. A minimum penalty of EUR 5,000 applies, regardless of any adjustment to income. A penalty of up to EUR 1,000,000 applies in case of late production of otherwise adequate documentation (minimum penalty of EUR 100 per day of lateness). If the Country-by-Country Report is not filed, the following penalties apply: EUR 10,000 for intent; EUR 5,000 for carelessness; and EUR 50,000 if it results in a careless tax reduction.

If transfer pricing adjustments are made, the timing with respect to the booking of the adjustment plays a crucial role. Depending on the date when adjustments are to be booked, high interest rates (six percent p.a.) are applied, which can easily accrue to a substantial +50% increase over the typical delays between the date when a transaction occurs, is audited, and the audit is finalized.

Germany applies very strict laws on fiscal offenses. If the documentation is not made in good faith and contains willful misstatements or omissions, criminal charges can be pressed

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against a taxpayer, and they are pressed very aggressively in some states. Tax law is one of the few instances of mandatory sentences in Germany. If the resulting tax effect of such a misrepresentation exceeds EUR 1 million, there is an automatic mandatory prison sentence without discretion by the judge.

6. Please describe any challenges taxpayers face in preparing their transfer pricing documentation in light of these changes in the audit process.

Due to the strict and in-depth audit process, taxpayers must respond quickly and provide all answers in good faith. That being said, it is generally important to conduct an initial meeting with the auditors to present the case and to provide an initial explanation of the intercompany business transactions.

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NOTES

[1] C.f. 4 *Transfer Pricing Forum* 31 (Sep. 30, 2013).
[2] § 90 AO – Abgabenordnung.
[3] § 1 ff. GAufzV (Gewinnabgrenzungsaufzeichnungsverordnung).
[4] § 90 Abs. 3 AO and § 1 ff GAufzV.
[5] § 138a Abs.1 AO.
[6] Gesetz über die Durchführung der gegenseitigen Amtshilfe in Steuersachen zwischen den Mitgliedstaaten der Europäischen Union (EU-Amtshilfegesetz) ("EUAHiG") § 7.
[7] AO § 117 Zwischenstaatliche Rechts- und Amtshilfe in Steuersachen.
[8] C.f. Vögele, A. / de Homont, P.: Turning "Corporate Tax Transparency" into a "Big Brother" Regime, BNA Transfer Pricing International Journal, 10/2017.
[9] § 1 ff. GAufzV.
[10] § 1 ff. GAufzV.
[11] For an extensive overview of the requirements for the documentation of facts, *see* 6 *Transfer Pricing Forum* 19 (July 31, 2015).
[12] § 90 Abs. 2 AO Abgabenordnung.
[13] § 90 Abs. 3 AO Abgabenordnung.
[14] Relocation of Functions legislation: Funktionsverlagerungsverordnung – FVerlV.