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Transfer pricing

Financier Worldwide canvasses the opinions of leading professionals around the world on the latest trends in transfer pricing.

Germany

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Yves Hervé has been a managing director in NERA's global transfer pricing practice since 2018. Prior to joining NERA, he was a transfer pricing partner at KPMG and German tax leader of the global value chain and digital transformation practice of PwC. Dr Hervé has covered major transfer pricing consulting issues for global clients, from integrated value chain structuring and transfer pricing planning to global transfer pricing compliance issues and documentation. His current focus is on providing economic analysis for dispute resolution and tax litigation.

Q. Could you outline some of the significant developments in the transfer pricing arena over the last 12 to 18 months? In what ways have these developments impacted how organisations go about implementing their tax planning strategies?

HERVÉ: The Organisation for Economic Co-operation and Development's (OECD's) Pillar One and Pillar Two initiatives are among the most significant developments. Despite concerns about practical implications on an administrative level, these initiatives are strongly endorsed by the German Ministry of Finance on a political level. Following the G7 Minister of Finance alignment meeting that took place in early June, it now seems likely that the initiatives will translate into international agreements, which will modify international group taxation throughout 2021. Many established tax planning and legal structuring setups, such as bundling intellectual property in low-tax and low-substance jurisdictions, will become unsustainable and obsolete. Multinationals have been expecting such developments for several years. While hoping international agreements would fail to materialise, many multinationals have started to review, ringfence or unwind certain structures

deemed unsustainable. This process is expected to accelerate going forward.

Q. To what extent are the tax authorities in Germany placing greater importance on the issue of transfer pricing? Have they increased their monitoring and enforcement activities?

HERVÉ: Transfer pricing is the dominant area of tax controversy in Germany. At the end of May, the German parliament approved the incorporation of the OECD transfer pricing guidelines within Article 1 of the German Foreign Tax Code, which will be a game-changer. Functional contributions to intangibles, such as development, enhancement, maintenance, protection and exploitation (DEMPE), will become the core of future transfer pricing analysis and controversy. Multinationals will have to massively enhance their transfer pricing documentation to show that DEMPE contributions across the group chain are properly considered. Because the German government regards the DEMPE concept only as a clarification of existing transfer pricing practice, one should expect DEMPE-related controversies will apply to previous years still open to tax audits. In inbound situations, German tax authorities already regularly challenge the applicability of the transactional net margin method to determine the arm's length distributor returns on the grounds that local market entities provide DEMPE contributions, disqualifying them as low-risk distributors. New 2020 administrative guidelines provide them with better tools to challenge established transfer pricing solutions by applying corroborating testing methods and allowing tax authorities to impose income adjustments if they deem their results to be more reliable than those of the taxpayer. This largely shifts the burden of proof against the taxpayer in tax audits and strengthens the negotiation power of tax authorities, which are under pressure to deliver additional corporate income tax revenue in fiscally distressed post-COVID-19 times. In a nutshell, the international and national regulatory developments combined with global macroeconomic developments provide the conditions for a perfect storm confronting multinationals. Germany will contribute heavily to increased tax disputes, double taxation, and more cumbersome and costly dispute resolution. Most likely, more important transfer pricing cases will appear in tax financial courts soon.

Q. Could you outline the challenges that companies face as they try to maximise their tax efficiencies while staying within the bounds of transfer pricing regulations? Is it becoming tougher to balance the drive for efficiency with compliance requirements?

HERVÉ: Going forward, the balance between efficiency and compliance requirements will shift to the latter. Transfer pricing compliance costs in accounting, documentation, tax audits and dispute resolution will increase massively, and managing the effective tax rate (ETR) and the cash burden will become secondary to being a good corporate and tax-compliant citizen. The group's management team, especially group and local chief financial officers (CFOs), will be increasingly exposed to personal and criminal liability risk in cases of compliance violations. Top management and boards of directors should expect to be pilloried by the public, non-governmental organisations (NGOs) and

the media for what are deemed to be aggressive tax planning schemes. This will come through new transparency requirements like the public country-by-country reporting requirements imposed by the European Union.

Q. What kinds of challenges arise in calculating appropriate transfer prices, both for tangible and intangible assets? How crucial is it to have consistent supporting documentation?

HERVÉ: Deemed DEMPE contributions to intangibles are already the most important source of transfer pricing disputes in Germany. For tangible product transactions, the usual challenge is that the local distribution company is deemed to conduct valuable intangible contributions in the field of marketing, such that the company should be entitled to higher non-routine returns on sales. For intangible transactions involving intercompany licences, the argument is similar. In inbound cases involving trademark licences, for example, it is argued that the licensee, through its local activities, contributes to the development, enhancement and maintenance of the trademark, and that a royalty rate that aims at transferring back the economic profit attributable to the trademark to the trademark owner is too high. Preventing or solving tax disputes related to these controversial issues needs proactive transfer pricing documentation, including a balanced DEMPE functional analysis in line with the OECD transfer pricing guidelines.

Q. Have you seen an increase in transfer pricing disputes between companies and tax authorities in Germany?

HERVÉ: There has been an increase in transfer pricing disputes in Germany, both in terms of scope and size. At the local audit level, unfortunately one must recognise that tax inspectors are ever more sophisticated and aggressive in imposing transfer pricing adjustments while adopting negotiation tactics that de facto try to blackmail taxpayers to accept some double taxation. The tactical behaviour of field tax inspectors often shows disregard for procedural administrative guidelines and burden of proof requirements. If taxpayers are willing to play hardball, completely unreasonable outcomes can usually be contained.

Q. What steps should companies take if they become the subject of a tax audit or investigation?

HERVÉ: Companies must be as locally compliant as possible in view of the latest OECD transfer pricing guidelines. Recognise that old-school plain vanilla and slim transfer pricing documentation reports, while cost effective to prepare, by being rolled out globally, are increasingly challenged and rejected by the German tax authorities. If the taxpayer is constrained due to group HQ constraints, conduct a local strengths, weaknesses, opportunities and threat (SWOT) analysis with your local transfer pricing adviser, anticipate the challenges to come, prepare secondary lines of defence, and back up evidence to sustain your position. Be proactive but not naïve when communicating with local tax authorities and prepare for war to ensure peace. Anecdotal evidence abounds of tax audits presumably running smoothly, with good communication with local tax inspectors, but where, out of the blue, taxpayers are confronted with massive

> *"Anecdotal evidence abounds of tax audits presumably running smoothly, with good communication with local tax inspectors, but where, out of the blue, taxpayers are confronted with massive transfer pricing adjustments."*

transfer pricing adjustments. Should a dispute arise, garner the assistance of experts in legal and economic controversy, and fight to win. Anticipate the complexity and risk of failure of subsequent dispute resolution mechanisms.

Q. In general, what advice would you give to companies on reviewing and amending their transfer pricing policies and structures?

HERVÉ: The DEMPE concept for intangibles in the OECD 2017 guidelines was a game-changer whose impact becomes ever more apparent over time. Multinationals should review their as-is transfer pricing models critically through a value chain analysis that is fully reflective of the DEMPE concept. If major gaps are visible, be proactive about necessary changes to your transfer pricing model, and address the issue openly, starting with your master file transfer pricing documentation. Be consistent and transparent in the methodologies you adopt and in communication with tax authorities. Transfer pricing adjustments inevitably are a zero-sum game: some countries and entities will win, others will lose. The income effect arising from compliance obligations to a changed global regulatory view on transfer pricing of intangibles should not give rise to compensatory and tax exit charge claims at a local level. ■

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