

# German 2021 Transfer Pricing — A Fundamental Shift in the German Transfer Pricing Landscape

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## Fundamental Changes in the Foreign Tax Act<sup>1</sup>

Sometimes the most radical shifts in life announce themselves in seemingly small details. The same can be said about the fundamental shift that is about to occur in German transfer pricing. A new law has been ratified, succinctly named *Abzugsteuerentlastungsmodernisierungsgesetz*<sup>2</sup>—roughly translated as “law on the modernization of withholding tax relief”—. The final version of the law has introduced far-ranging modifications and wholesale replacements on transfer pricing matters to the German Foreign Tax Code.

Effective beginning in 2022, three core aspects of the Foreign Tax Code will be modified, as detailed below. While many of these changes were expected and move Germany into greater alignment with the OECD Transfer Pricing Guidelines, the practical implications will be far-reaching, in particular because German transfer pricing audits generally go into great detail. Therefore, we expect a new wave of disputes to arise as the tax authorities apply the new standards.

## Transfer Pricing Method Selection and Applicability

The German Foreign Tax Code had previously been lagging behind the international consensus in the selection of transfer pricing methods. In particular, it still contained a formal preference for the “standard” transfer pricing methods—the comparable uncontrolled price method, cost-plus, and resale minus, over other methods, such as TNMM and the profit split method. This hierarchy of methods had been abolished by the OECD already in 2010 and, now, Germany effectively aligns with the OECD.

In some respects, the law confirms the existing practice, in particular regarding the widespread use of TNMM and a clearer reference to the use of interquartile ranges. While these are welcome clarifications, these changes are not expected to have significant practical implications.

However, the new law also includes a clear strengthening of economic analysis, and explicitly prescribes the use of “accepted economical valuation methods” to determine the arm’s length price from the perspective of both transacting parties. These provisions will lend a stronger foundation to the use of state-of-the-art economic valuation techniques, which will enable taxpayers to provide better and more comprehensive evidence of their



transfer pricing practices. On the other hand, it will also increase the technical sophistication of tax authorities’ analysis.

## DEMPE Concept and Definition of Intangibles

The new provisions of the Foreign Tax Code will now also include both an endorsement of the DEMPE<sup>3</sup> concept, as well of the (new) definition of intangibles per the OECD guidelines and the BEPS project.

Both of these changes can be expected to lead to more transfer pricing controversy. Previously, the German guidelines had explicitly mentioned only intangible assets, but now taxpayers must recognize that anything that is not a financial or physical asset can be considered an intangible as long as it gives rise to some value, even if it is not recognized for further accounting purposes. Furthermore, the economic ownership of these intangibles is to be assessed by a compulsory DEMPE analysis (i.e., an analysis of the entities contributing to the development, enhancement, maintenance, protection, and exploitation of intangibles). Crucially, the law now explicitly states that funding the development, maintenance, or protection of an intangible per se does not entitle the respective entity to the returns associated with an intangible. As such, in transfer pricing matters, the importance of legal ownership of intangibles is replaced by an assessment of functional ownership, a field that, due to inevitable subjectivity, is prone to future tax disputes.

Overall, the combination of a wider definition of intangibles and a broader assessment of economical ownership will lead to more local entities being classified or reclassified as entrepreneurial companies. The transfer pricing implication is that the use of two-sided methods, such as the profit split method, can be expected to proliferate. For German inbound cases, transfer pricing solutions justified through one-sided TP methods are increasingly likely to be challenged.

“THE LAW HAS INTRODUCED FAR-RANGING MODIFICATIONS AND WHOLESALEREPLACEMENTS ON TRANSFER PRICING MATTERS”

## Relocation of Functions/Hard-to-Value Intangibles

German transfer pricing rules are (in)famous for the regulations regarding the “relocation of functions” (*Funktionsverlagerung*), which were introduced in 2010. The new law adapts these rules and aligns them with OECD guidance on “hard-to-value intangibles,” although its application is set to be somewhat broader.

The Foreign Tax Code now specifies that any transfer of relevant intangibles (including in the context of a relation of functions) is subject to an adjustment payment if the ex-post results deviate significantly from the ex-ante expectations (EBIT, revenues, etc.) used in the valuation. In line with the OECD guidance, the adjustment payment should be made if the deviations would, under the original valuation methodology, lead to a price that deviates by more than 20% from the original transfer price. In a slight deviation from the OECD’s suggestion, in Germany, this reassessment is to be made no later than seven years after the transaction instead of 10 years. Notably, this is also a deviation from the previous rules on the relocation of functions, which had also prescribed a 10-year period.

There are several noteworthy exceptions to the adjustment clause that are explicitly mentioned in the new law, again somewhat in line with OECD guidance. No adjustment clause is required for i) deviations stemming from circumstances that were completely unforeseeable, or ii) if the potential deviations were explicitly and appropriately considered in the original valuation, or iii) if the transfer is accompanied by a license agreement that is based on either revenues or profits of the licensee. Moreover, tax authorities can only make these adjustments if the taxpayers have not used an “appropriate” adjustment clause themselves.

Overall, the application of the relocation of functions will move closer to the transfer of an intangible and will likely be seen in the

same overall framework. This is somewhat confirmed by the fact that two of the three previous exceptions to the exact calculation of the transfer price for a relocated function are deleted from the regulations. Previously, it had not been necessary to value a function based on the detailed guidance if it could be shown that either i) the function contained a single, significant intangible that could be valued, or ii) it contained various intangibles, the sum of which corresponded to the result under the detailed guidance. In practice, these exceptions were of lower importance, in particular since they still contained a reference to the value under the detailed guidance and, therefore, did not lead to much simplification. The only remaining exception applies when a function is relocated without the transfer of any intangible, which is generally assumed if the relocated function is purely routine.

## Outlook

The changes will be effective as of the 2022 financial year but, in practice, tax authorities will already consider some elements and updated interpretation of the existing arm’s length principle and, thus, try to apply it even to preceding tax years. Nevertheless, some regulations, especially the “hard” ones (e.g., on thresholds for the application of adjustment payments), are only applicable starting next year.

As part of the legislation the new law, the Ministry of Finance is authorized to issue new detailed regulations (*Rechtsverordnung*) to clarify the application of the law, in particular the arm’s length standard. These regulations will be subject to approval by the upper legislative chamber and will likely have profound implications in practice. However, this detailed guidance will take some time to develop and ratify, so taxpayers should prepare now to ensure that their transfer pricing documentation and application—especially regarding DEMPE functions—is in line with the new German regulations.

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1. *Außensteuergesetz*

2. Full title is “Gesetz zur Modernisierung der Entlastung von Abzugsteuern und der Bescheinigung der Kapitalertragsteuer.”

3. Where DEMPE stands for the functions that develop, enhance, maintain, protect, and exploit an intangible.