

German Ministry of Finance issues new Administrative Principles regarding examination of income allocation between internationally associated enterprises

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Executive summary

Germany has had administrative principles in place since 2005 that, among other things, provide guidance regarding the obligations of taxpayers when undergoing a transfer pricing examination (See, Administrative Principles Procedures, BMF letter of 12 April 2005 or AP 2005). On 3 December 2020, the German Ministry of Finance (BMF) updated the AP 2005 by issuing the *Administrative Principles 2020 (AP 2020)*.

The revisions focus on two chapters of the AP 2005, those being the: (i) obligations of taxpayers (and their relevant related parties) to cooperate (Sec. 90 Fiscal Code (FC)); and (ii) estimation of tax bases and penalties by German tax authorities (Sec. 162 FC). The parts of the AP 2005 not modified by the AP 2020 remain intact.

Germany's Administrative Principles represent a third element (in addition to the tax law and executive orders) of German tax provisions. Although not binding on taxpayers and courts, the Administrative Principles serve as additional guidance for the interpretation and illustration of the tax law and executive order; accordingly they are important for taxpayers.

This Alert summarizes the key aspects of the AP 2020.

Detailed discussion

It was widely anticipated that under the AP 2020, the German tax authorities would (re)interpret the arm's-length principle following the revision of the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines in 2017. The AP 2020 contains certain necessary additions due to the changes in German tax law, in particular resulting from the completion of the OECD Base Erosion and Profit Shifting (BEPS) Project. Importantly, the AP 2020 does not mention the OECD's "DEMPE Concept."¹ On the other hand, the AP 2020 contains comments on the implementation of the master file in Germany with clarifications on the determination of revenue thresholds and on the interpretation of undefined legal terms.

The AP 2020 focuses solely on procedural aspects which play an increasingly important role in German tax audits. Many tax auditors have interpreted the provisions addressing taxpayers' obligations to cooperate and the evidence to be provided on the appropriateness of their transfer prices broadly. Similarly, they have viewed their own discretion to perform estimations in the event of violations of these alleged obligations broadly. The AP 2020 confirms these broad interpretations of the applicable law.

Particularly, it is important to consider the following:

- ▶ The AP 2020 sets forth comprehensive precautionary evidence obligations for taxpayers that are involved in cross-border transactions. According to the view of the German tax authorities, a taxpayer has to ensure comprehensive access rights to foreign information when entering into an agreement (see para. 14f.). Therefore, the requirements as defined in the AP 2020 go beyond the jurisprudence of the German Federal Fiscal Court (FFC), which had placed such an obligation under the reservation of the arm's-length principle (see FFC dated 17 October 2001, I R 103/00).
- ▶ It is important to note that the BMF still requires that documents are translated into German. Thus, even if an application by the taxpayer to submit transfer pricing documentation in English is approved, tax auditors may still request full translation of the documents if they deem it necessary. To avoid adverse consequences such as "submitted documents are deemed to be unknown" (para. 22) or even "unusable" (para. 34), taxpayers can expect considerable translation costs on the basis of the provisions with respect to language requirements.
- ▶ The documents to be presented to German tax authorities in a tax audit context should also include emails, messenger service messages and expert opinions from tax advisors, insofar as their content has tax relevance. It remains unclear how these documents should/could be stored/saved respectively and how this requirement aligns with confidentiality considerations.
- ▶ According to para. 67 of the AP 2020, taxpayers are required to disclose information that is within their sphere of knowledge based on their own initiative - and not just upon request by German tax authorities. A violation of this obligation allows an estimation of tax bases by German tax authorities to the detriment of the taxpayer according to Sec. 162 para. 2 FC.
- ▶ The taxpayer is required to submit the underlying agreements as part of the factual analysis in the transfer pricing documentation (para. 43). To date, only an overview of the agreements had to be attached to the transfer pricing documentation. In addition, the balance sheets of all parties involved (domestic and foreign), including the individual financial statements that can be consolidated, must also be submitted as part of the economic analysis (para. 51). With respect to the application of the hypothetical arm's-length analysis, often applicable in the context of German exit taxation, a sensitivity analysis of the valuation parameters is required (para. 47).
- ▶ The German tax authorities have the discretion to select the most appropriate transfer pricing method to test the arm's-length nature of transfer prices (para. 46). To enable the German tax authorities in doing so, the taxpayer is required to provide the necessary information as part of his obligation to cooperate.
- ▶ In general, the AP 2020 allows taxpayers to perform the arm's-length test on the basis of the arm's-length data available at the time of concluding the agreement as well as on the basis of the arm's-length data that becomes known at a later point in time (para. 49). However, the German tax authorities are also granted the right to perform the arm's-length test based on arm's-length data that becomes known at a later point in time (para. 73). This aspect raises the concern that even in situations where the taxpayer prepares contemporaneous transfer pricing documentation, i.e., taking into account arm's-length data available at the time of concluding the agreement, German tax authorities may argue for a transfer pricing adjustment by referencing para. 73.

- ▶ If the German tax authorities use a different transfer pricing method than the taxpayer for testing purposes, a transfer pricing adjustment shall be applied, if the results of the alternative method are “more likely” (para. 46). Similarly, transfer pricing adjustments can also be made with respect to a transfer pricing documentation that is deemed “sufficient” by German tax authorities if the transfer prices applied by the taxpayer “are highly unlikely” in line with the arm’s-length principle and the transfer prices determined by the German tax authorities are “at least more likely” (para. 73). The AP does not provide any definition or further explanation of the term “likelihood”, which is expected to result in increased disputes during German tax audits.
- ▶ Transfer pricing documentation shall be deemed as “insufficient” triggering an estimation right for German tax authorities, if e.g., the represented facts are not correct, the comparability analysis does not provide sufficient justification with respect to the comparability of arm’s-length data or the application of the selected transfer pricing method is not presented (para. 82).

Implications

The extent of taxpayers’ obligations to cooperate and keep records in the field of transfer pricing has developed into one of the most controversially discussed issues in German international tax law. The AP 2020 strengthens the already broad position of the tax authorities, but as administrative principles, they are not binding for taxpayers and the tax courts. It remains to be seen whether the German tax courts will limit the broad requirements of the tax authorities in the future. Therefore, affected taxpayers should not accept prematurely the often broad requests of tax auditors and should not rule out judicial clarification, especially with regard to procedural aspects.

In closing, the BMF’s position appears to be that the German tax authorities need stricter rules, notwithstanding that Germany is the worldwide leader with respect to pending mutual agreement procedures,² extensive tax audit activities in the area of transfer pricing and continuous global efforts³ to reduce disputes regarding profit distribution in multinational groups.

Endnotes

1. Note 6.32 OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris.
2. <https://www.oecd.org/tax/dispute/2019-map-statistics-germany.pdf>.
3. <https://www.oecd.org/tax/forum-on-tax-administration/international-compliance-assurance-programme.htm>; Council Directive (EU) 2017/1852 of 10 October 2017 on procedures for the settlement of tax disputes in the European Union.

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