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PREFACE

It has been a great pleasure to edit this third edition of The Transfer Pricing Law Review. This publication aims to give readers a high-level overview of the principal transfer pricing rules in each country covered in the Review. Each chapter summarises the country’s substantive transfer pricing rules, explains how a transfer pricing dispute is handled, from initial scrutiny through to litigation or settlement, and discusses the interaction between transfer pricing and other parts of the tax code (such as withholding taxes, customs duties, and attempts to prevent double taxation).

Other than Brazil, which adopts a mechanical approach, all the countries covered in this Review apply an arm’s-length standard and adhere, at least to some extent, to the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines). However, as the chapters make clear, there remains significant divergence, both in countries’ application of the arm’s-length standard (e.g., the transactions it applies to, the pricing methods preferred and whether secondary adjustments are imposed) and in the documentation requirements imposed. Transfer pricing practitioners, therefore, cannot simply assume that the OECD Guidelines contain all the answers but must in fact engage with their detailed application within each country.

However, as (almost) all large economies apply an arm’s-length standard in transfer pricing, case law from other countries can often shed light on how the OECD Guidelines should be applied – for instance, the Canadian decision in Cameco, on the Canada Revenue Agency’s power to recharacterise transactions on arm’s-length grounds, will be valuable reading for anyone involved in a similar debate with their own tax authorities.

As we have said in earlier editions of the Review, transfer pricing rules will continue to be high on the corporate tax agenda for many years to come, and they are continuing to evolve at a rapid pace. Over the next year or so, we expect the following to be the three areas of principal focus.

First, more countries than has hitherto been the case have adopted the recommendations on transfer pricing from Actions 8–10 of the Base Erosion and Profit Shifting Action Plan (which attribute more value to significant people functions rather than capital or contractual risk allocation). This is likely to lead to more disputes in the short to medium term, especially where functions are split across different countries and allocating returns between them can be a difficult and contentious exercise.

Second, the European Commission is continuing to use its state-aid powers to drive the transfer pricing agenda. Many of the high-profile transfer pricing state-aid cases (Apple, Amazon, etc.) will shortly reach the EU’s General Court. Recently, in the opening decision in Huhtamaki, the Commission criticised a Luxembourg regime that provided for transfer pricing adjustments that reduced Luxembourg companies’ taxable profits, arguing that this
should only be done where necessary to avoid actual double taxation. In contrast, it could be argued that the Luxembourg regime is consistent with the principle that a country should tax the value that, at arm’s length, is actually generated there.

Third, digital taxation continues to dominate the transfer pricing debate, with several countries announcing digital services taxes, or other regimes, such as the UK tax on offshore receipts in respect of intangible property, which operate independently of arm’s-length transfer pricing rules. More broadly, the OECD’s current consultation on taxing the digital economy proposes several measures that expressly depart from the arm’s-length standard – for example, by deeming that all or part of the reward from marketing intangibles arises in the customer’s jurisdiction, even if none of the functions controlling that intangible are located there.

Finally, we would like to thank the authors of all of the country chapters for their comprehensive and illuminating analysis of each country’s transfer pricing rules; and the publishing team at Law Business Research for their diligence and enthusiasm in commissioning, coordinating and compiling this Review.

Steve Edge and Dominic Robertson
Slaughter and May
London
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I OVERVIEW

In German tax law, there is not one consolidated section of statutory rules on transfer pricing, but several provisions in different legislative acts. The rules on constructive dividends and Section 1 of the Foreign Tax Act (FTA) are most influential for the tax treatment of transfer pricing. The concept of constructive dividends and Section 1 are interpreted by case law and are supplemented by various legislative regulations and administrative circulars (including the Administrative Principles on the Transfer of Functions).

German transfer pricing rules and principles cover all sorts of business transactions concluded between German taxpayers and related parties abroad. In a nutshell, all related-party transactions not based on the statutes of association between (direct and indirect) shareholder (or partner) and company (or partnership) are subject to the arm’s-length standard. This is regardless of whether the transactions are income or capital transactions. In addition, all transactions between a head office and its permanent establishment (PE) are covered, whether they are explicitly declared dealings or not. The term ‘dealing’ refers to fictitious cross-border transactions between a head office and its PE. Examples are inter-company sales (also investments) and services, loans or guarantees and intellectual property (IP) licensing arrangements, as well as the transfer of functions between related parties.

The definition of a related party goes beyond mere group companies, family members and relatives. Based on statute, a related party can be any party that is in a position to exert influence on a taxpayer or that has a special interest in the income generated by the taxpayer going beyond a regular business interest.

In practice, however, German tax authorities focus on transactions between group companies with direct or indirect shareholdings of at least 25 per cent,\(^2\) as well as on transactions between members of a family.

There is a dual aspect to German transfer pricing law, which considers both the arm’s-length principle and the concept of the prudent and diligent managing director of an independent enterprise. In general, the classic arm’s-length principle must be applied to cases where empirical data to determine arm’s-length prices is available (the fact-based or factual arm’s-length test). The concept of the prudent and diligent managing director is used, in particular, to obtain an arm’s-length transfer price for inter-company transactions where empirical data with appropriate costs cannot be found (the hypothetical arm’s-length test).

\(^1\) Stephan Schnorberger is a partner and Rabea Lingier is an associate at Baker McKenzie.

\(^2\) Section 1(2) FTA.
Germany has started to implement the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project Final Reports, such as the BEPS 2015 Final Report on Action 13 on transfer pricing documentation and country-by-country reporting. As long as OECD guidance or papers are not passed into law, neither the German tax administration nor the German tax courts are legally bound by them. This also applies to the OECD Commentary on the Model Convention and to the OECD Transfer Pricing Guidelines. Nevertheless, OECD guidance constitutes a relevant source of interpretation that can be used to determine arm’s-length prices. In 2013, in response to the Authorised OECD Approach (AOA) to the allocation of profits between a head office and its PE, the German legislature adopted the AOA into German law with certain deviations. Even though specific AOA language on head office–PE profit allocation has only been included in a few German double-tax treaties, the administration holds that the AOA takes precedence in the majority of cases, in particular when the contracting state is an OECD member. In addition, the German AOA rules generally prevail over profit allocation rules in the applicable double-tax treaty.

II FILING REQUIREMENTS

In 2003, the German legislature introduced a statutory obligation to document transfer prices and their arm’s-length nature. The statute provides that taxpayers are required to prepare documentation on cross-border transactions with related parties.

In line with OECD BEPS Action 13, the German legislature expanded the transfer pricing documentation requirements. The taxpayer must prepare not only a local file, but also a core file (master file), unless the enterprise’s annual revenue has been less than €100 million in the preceding financial year. Transfer pricing documentation for ordinary business transactions must be submitted within 60 days of a request by the German Tax Authority, usually in the course of a tax audit. Contemporaneous preparation of transfer pricing documentation is not required but is recommended as the taxpayer has to document a number of facts regarding the price setting. There is no legal obligation to prepare annual documentation on ordinary, ongoing related-party transactions. Under general principles, documentation has to be updated or recreated when changes to conditions occur that significantly affect prices or margins.

An exception is that extraordinary business transactions have to be documented contemporaneously, that is, at the latest, six months after the end of the business year in which the transaction took place, and documentation has to be submitted within 30 days of the request. According to legislative regulations, extraordinary transactions are, in particular:

a the conclusion and amendment of long-term contracts that have a significant impact on the income the taxpayer derives from its business relations;

b the transfer of assets in the context of restructuring measures;

c the transfer and use of assets in connection with significant functional and risk changes at the company;

d business transactions in connection with changes in business strategy that are significant for transfer pricing; and

e the conclusion of cost allocation agreements.

3 Section 90 General Tax Code, complemented by Gewinnabgrenzungsaufzeichnungsverordnung (G AufzV).
The documentation regulations (GAufzV) were updated in 2017 to further reflect OECD recommendations. The new rules also put more emphasis on value chain analyses and economic substance requirements. Domestic rules on the preparation of a local file (opposed to the group master file) are generally in line with the OECD BEPS Action 13 recommendations. Additionally, the new law requires taxpayers to document the time of transfer price setting, and to provide detailed information on the database and search strategy used in determining an arm’s-length price or margin. Master-file requirements are also in line with the OECD BEPS Action 13 recommendations, and the revised GAufzV are applicable as of fiscal year 2017. It is expected that the Administrative Principles–Procedure will also be amended accordingly.

According to Section 6(2) GAufzV, enterprises with inter-company sales of goods of no more than €6 million (paid or received) per annum or inter-company provisions of services of no more than €600,000 per annum (paid or received) are exempt from the documentation requirements.

The documentation requirements also cover head office–PE dealings and the allocation of assets between the head office and PEs.

A German-based entity with a PE abroad and non-German entities with a PE in Germany have to prepare an ‘auxiliary and complementary statement’. In principle, this is in addition to annual statutory and tax accounts.

The auxiliary and complementary statement has to be set up at the latest before the deadline for submission of the annual tax return. However, it is not part of the tax return; it only needs to be submitted upon request. The auxiliary and complementary statement includes (tangible and intangible) allocated assets, allocated free capital, allocated liabilities, associated payables and receivables, and constructive income from internal dealings as well as opportunities and risks transferred from the head office to the PE. In line with OECD guidance, the auxiliary and complementary statement has to record intangible values that are not assets in the tax accounting sense of the term.

In addition, annual country-by-country reporting (CbCR) is required where certain criteria are met. German group parent companies recording consolidated sales revenues of at least €750 million have to prepare annual CbCRs on the group’s sales revenues, income tax paid during the fiscal year, equity capital, number of employees, tangible assets, etc. On the other hand, foreign group parent companies are not required to disclose this information in Germany; however, assuming the foreign group parent has recorded revenues of €750 million or more in the preceding fiscal year, and the Federal Central Tax Office has not received the CbCR from the country of residence of the parent, German subsidiaries are required to disclose the CbCR. In this case, each German group subsidiary is obliged to submit the CbCR, or at a minimum any CbCR data to the extent available.

To sum up, according to Section 138a GTA, there are three scenarios in which German companies become obliged to file the CbCR in Germany:

a the company is the ultimate holding company of the group preparing consolidated financial statements according to German or foreign GAAP;

b a foreign parent company employs the German company for surrogate filing.

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4 Verwaltungsgrundsätze-Verfahren.
5 Section 138a(4) GTA.
6 Section 138a(1) GTA – ‘resident group holding company’.
7 Section 138a(3) GTA – ‘appointed resident group entity’.
the German company should be included in the foreign parent company’s CbCR filing, but the Federal Central Tax Office has not received CbCR data, in which case the German company is obliged to submit the CbCR for the group, or at least CbCR data to which it has access.\(^8\)

In its annual tax filing, the German company has to declare which of the above categories it belongs in.\(^9\) With regard to the procedure, it is important to note that preparing and submitting a CbCR is a reporting or notification obligation, but not a documentation obligation.

III  PRESENTING THE CASE

i  Pricing methods

In line with the OECD Transfer Pricing Guidelines, Section 1(3) FTA provides for the statutory priority of the standard methods, which are the comparable uncontrolled price (CUP) method, the resale minus method and the cost-plus method. If the data available is fully comparable with the tested transaction prices, the full range of these arm’s-length values is used. As the application of the CUP method requires very strong comparability, it is seldom applied. Typically, the CUP method is applied for the sale of fungible goods taking place at the same level of the commercial chain, as well as for financial transactions. The resale minus method is frequently applied for sales and marketing transactions, as well as for distribution activities. The cost-plus method is mostly applied for the sale of goods by a manufacturer who does not contribute valuable and unique intangibles and does not assume significant risks. The same is true with regard to the provision of services.

If fully comparable arm’s-length values cannot be determined, the transfer price method must be based on partly comparable values. If this is the case, appropriate adjustments must be made, provided they improve comparability, and the resulting range of arm’s-length values must be narrowed down, usually to the interquartile range. If the actual transfer price is outside this range, adjustments are made to the median of the range.

Methods other than the standard methods are the transactional net margin method (TNMM) and the residual profit split method. These methods are regarded as transactional profit methods. Pursuant to administrative regulations, the German tax administration will only accept the TNMM if it is used to price a limited-risk ‘routine’ transaction (e.g., low-risk service provider or manufacturing activities). The residual profit split method is said to be accepted only where standard methods cannot be applied (reliably). The regulations exemplify this situation by reference to the global trading of financial products and, more generally, to the situation of two or more market-facing entrepreneurs making unique and valuable intangible contributions that are highly integrated.

Transfer pricing methods that are based on global profit allocation, such as the comparable profits method (CPM), are not accepted by German tax authorities.

If neither fully nor partly comparable arm’s-length values can be determined, the taxpayer must apply a hypothetical arm’s-length range. The range is derived from the maximum price acceptable for the payer (buyer) and the minimum price to be charged by the

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\(^8\) Section 138a(4) GTA – ‘included resident group entity’.
\(^9\) Section 138a(5) GTA.
payee (seller). Once a range between maximum and minimum prices has been established, the price that is most likely to be at arm’s-length should be applied. The default value within the range is the midpoint value between the maximum and the minimum price.

Special valuation rules apply for determining a hypothetical arm’s-length price for the transfer of a function (business restructurings in OECD terminology). According to these rules, the hypothetical arm’s-length transfer price is determined as a ‘transfer package’. The transfer package consists not only of the individual assets associated with the production and the sales or service function transferred, but also includes business opportunities, risks and potential location savings, as well as synergy effects.

In line with international standards, German regulations do not provide for safe havens. Arm’s-length transfer prices have to be determined case by case, taking into account all applicable facts and circumstances.

Although disputed in lower tax courts,10 the ‘Knoppe formula’ is a common ‘method of last resort’ for cross-referencing royalty rates. According to the rule, royalty rates should not exceed 33 per cent and should not be lower than 25 per cent of the incremental licensee operating profit. As tax administrators can be expected to rely more and more on profit splits as a result of the BEPS approach adopted by the OECD, and as comparability expectations increase, reliance on the Knoppe formula can be expected to become a more challenging position.

ii Authority scrutiny and evidence gathering

The German tax authorities do not usually conduct special transfer pricing audits but examine transfer prices during the normal course of regular tax audits, which are conducted at regular intervals.

There are specific administrative regulations11 regarding the selection of companies for an audit.

According to the law, German tax authorities have the duty to investigate facts and circumstances neutrally, be they detrimental or favourable for the taxpayer.

The taxpayer has the duty to cooperate and to assist the tax auditor by answering the auditor’s questions in written or oral form, and by making available relevant information, notes and documents for inspection. In addition, taxpayers are obliged to submit transfer pricing documentation upon request and provide documents and evidence for cross-border transactions.

In general, the burden of proof that transfer prices are not at arm’s length is on the tax authorities. But, if the taxpayer does not fulfil its duties to cooperate or if the transfer pricing documentation is deemed essentially unusable, the tax authorities may in many cases estimate the taxpayer’s income based on a rebuttable presumption that the transfer prices as declared in the tax return are not at arm’s length. Thus, failure to present appropriate documentation may de facto result in a shift of the burden of proof.

German tax authorities keep expanding their resources in the area of transfer pricing. Many local tax offices have dedicated audit teams specifically trained in transfer pricing and international tax matters. Recently, tax authorities have started building up teams of valuation experts. These focus aggressively on valuations of intangibles, functions and businesses, among other things. In the course of a tax audit, the local tax auditor may refer a valuation

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10 Lower Tax Court of Münster, 14 February 2014, 4 K 1053/11 E.
11 Tax audit regulations – Betriebsprüfungsordnung (BpO).
question to such an expert acting as an adviser to the tax auditor. In matters of international importance, specialised tax auditors of the Federal Central Tax Office may come in. Typically, transfer price auditors of the Federal Central Tax Office have particular industry expertise.

At the level of the Federal Central Tax Office, extensive statistical information on international tax matters and transfer prices is collected. This information is confidential and is only available to the tax authorities. In a 2001 decision, the German Federal Tax Court ruled that the use of anonymous data does not, per se, violate German tax procedures if the data is presented in a way that allows the taxpayer to assess and comment on the data. This requirement effectively eliminates the tax authorities’ ability to rely on anonymous comparables in tax administrative and tax court proceedings. Nowadays, German tax authorities routinely use publicly available databases to cross-check benchmark studies presented by the taxpayer or to conduct their own analyses. Benchmark studies are often used for price-setting purposes. However, the application of benchmark studies as a price-testing approach is recognised in practice.

Transfer price findings continue to be a significant issue in tax audit practice. Key areas of fiscal interest are, in particular, the following:

a. German distributors or routine-manufacturers reporting low profits or incurring significant losses: in this context, there is a trend among German tax auditors to argue that a loss-making, business-wise autonomous German subsidiary renders market penetration services to the group leading to a cost-plus remuneration;

b. business changes, transfers of functions and intangible migrations and compensations for these;

c. royalty charges: fuelled by recent court decisions, German tax authorities increasingly focus on outbound licences for the use of corporate group names;

d. transfer prices in the context of principal structures (in particular limited risk distributor and intellectual property structures);

e. remuneration of non-routine service activities and allocation of synergies (i.e., in the context of central procurement companies);

f. PEs and profit allocation between head office and PE;

g. remuneration in line with development, enhancement, maintenance, protection and exploitation functions (known as DEMPE functions), arm’s-length intangibles remuneration and the economic nexus approach;

h. intra-group financing; and

i. recharacterisation of transfer pricing models to profit split models.

Furthermore, the German tax authorities increasingly initiate and execute joint audit procedures, both within the EU and with the United States.

IV INTANGIBLE ASSETS

In line with OECD BEPS Action 5, Germany introduced regulations on the limitation of the deduction of royalties (licence barrier), effective as of 31 December 2017. The statute is intended to focus on foreign ‘IP box’ regimes incompatible with the OECD nexus approach. The licence barrier limits the deduction of licence fees as expenditures provided the licensor is a related party; the royalty income of the licensor is taxed under a special regime deviating from the standard rules (preferential regime); and the royalty income is
subject to low taxation (below 25 per cent). Two major exceptions are made if the preferential regime is in line with the OECD nexus approach as set out in Chapter 4 of the BEPS 2015 Final Report on Action 5, or if income is subject to controlled foreign company taxation in Germany. Currently, the Federal Ministry of Finance is reported to be analysing whether the US Foreign-Derived Intangible Income regime triggers limitations of royalty deductions.

Apart from this recent legislative development, tax audits have always focused on the substance underpinning major foreign income abroad and the corresponding deductions made in Germany. Against the background of the OECD BEPS project, the aggressive scrutiny of substance has already increased and can be expected to increase further.

V SETTLEMENTS

Bilateral or multilateral advance pricing agreement (APA) procedures are available, based on double-tax treaty rules for mutual agreement procedures (MAPs).

In principle, both unilateral rulings and bilateral and multilateral APAs are available in Germany. However, the Federal Ministry of Finance has issued administrative regulations stipulating that in cases where a double-tax treaty contains a clause on MAPs, the German taxpayer should not be granted a unilateral ruling. However, where no double-tax treaty exists, the tax authorities may, on request, provide the taxpayer with a unilateral APA, provided that the specific case is deemed appropriate and the taxpayer has a bona fide interest.

APA requests do not prevent tax audits; on the contrary, they tend to trigger audits. In fact, there is a standing administrative practice of cooperation between the Federal Central Tax Office and the local tax audit units.

The APA request has to be filed with the Federal Central Tax Office, which is the competent authority. The scope of application in terms of both content and period has to be defined in the application request. The applicant has to explain the request in detail and provide all necessary records. The tax authorities may make additional queries at any time and demand further information and documents. In addition, the applicant should also suggest critical assumptions.

For each fiscal year covered, the taxpayer must submit a report to the Federal Central Tax Office stating and proving compliance with the critical assumptions of the APA.

In practice, APAs are usually granted for a period of three to five years. Their term generally commences at the beginning of the fiscal year in which the formal request is filed. An earlier commencement may be allowed if, on the date when the APA request is filed with the Federal Central Tax Office, a tax return has not yet been submitted and the statutory deadline for submitting the tax return has not yet expired. The Federal Central Tax Office may also grant a rollback under certain circumstances, especially if the other country consents.

Further, the EU Mutual Assistance Directive has been implemented into domestic German tax law in the EU Mutual Assistance Act. The supplement to the Directive provides for the automatic exchange of cross-border tax rulings and APAs on transfer prices between multinational companies (tax rulings). In respect of this function, the Federal Central Tax Office provides certain information on tax rulings issued, changed or renewed as of 1 January 2017, to the respective authorities of the Member States (known as the receiving authority) and the European Commission automatically.

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13 EU-Amtshilfegesetz.
VI INVESTIGATIONS

German tax audits are notorious for taking a very down-to-earth approach, focusing on details of facts and accounting. German audit offices do not employ university-trained economists but rely on internally trained specialists, so that proposed transfer price adjustments are regularly short on fact-based, empirically grounded economic theory. This contrasts with the advanced technical and methodical approach of tax audit valuation specialists.

Transfer pricing disputes have traditionally been settled by negotiation and compromise in the audit or in post-audit administrative appeals. This is the reason why there used to be only limited case law on transfer pricing in Germany; however, in view of the increasing aggressiveness of German tax authorities in transfer pricing matters, taxpayers are becoming more willing to take their cases to court. Indeed, the number and frequency of court decisions on transfer prices has increased.

VII LITIGATION

i Procedure

Generally, the following appeal options are available in Germany. The taxpayer can file administrative or court appeals. There are only two court instances. Whereas the local tax court (first instance) both investigates the facts and finds on the law, the Federal Tax Court strictly focuses on a revision of questions of law, be they substantive or procedural in nature (second instance). Where questions of European law are critical for a decision on the case, local tax courts may, and the Federal Tax Court is obliged to, refer the case to the European Court of Justice. Once legal court instances are exhausted, the taxpayer may raise a complaint with the Federal Constitutional Court for violation of constitutional rights. The Court decides whether to admit the complaint.

In addition to this, MAPs and arbitration procedures pursuant to double-tax treaties or the EU Arbitration Convention are used successfully to resolve double taxation. Tax authorities have been making more, and larger, transfer price adjustments, and have increasingly been adopting a more inflexible stance, even in the final audit meeting. At the same time, the Federal Central Tax Office has been seen to raise more and more onerous requirements before confirming the initiation of a MAP. Consequently, after weighing the pros and cons of the dispute resolution options, taxpayers choose tax litigation more often than not.

ii Recent cases

The following are some of the most important transfer pricing rulings that have been issued by the Federal Tax Court since 2000:

a There have been several decisions on whether or not a group subsidiary can deduct royalty fees for a licence to use a branded corporate group name. In 2000, the Federal Tax Court ruled that royalty charges for the use of the corporate group name may be tax-deductible if it is a protected trademark or brand name whose use affords valuable benefits to the licensee. However, a later decision by the Lower Tax Court of Munich demonstrates that deducting a royalty charge requires there to be effective legal and

14 I R 12/99.
15 6 K 578/06.
practical benefits for the licensee. In a recent decision, the Lower Tax Court of Münster decided that the arm’s-length principle requires a licence to be implemented for the use by a foreign entity of a corporate group name when the trademark has value in itself. In a case in 2016, the Federal Tax Court reversed this controversial lower court decision. In essence, the Federal Tax Court decided that a usage of name rights does not establish a business relationship within the meaning of Section 1(4) FTA, if the right to use is given to the subsidiary at a corporate level (e.g., in consideration of shares). New administrative regulations on the use of group names, trademarks and logos were published on 7 April 2017. These administrative regulations apply in all pending cases and largely disregard the Federal Tax Court decision. Therefore, it is to be expected that further tax court proceedings will be initiated.

In a landmark decision of the Federal Tax Court in 2001, the court clarified important procedural aspects of transfer pricing rules and regulations, in particular on the burden of proof, transfer pricing documentation, the taxpayer’s duty to cooperate with the tax authorities and the use of secret comparables. As a reaction to the ruling, the German legislature introduced important changes in German transfer pricing law (transfer pricing documentation, penalty rules and refinement of the arm’s-length principle in Section 1 FTA) that partly supersede the court’s decision.

A 2004 decision of the Federal Tax Court addresses the arm’s-length principle and states that to define an arm’s-length price, the positions of both (theoretical) contracting parties, their profit expectations and alternative actions (similar to ‘options realistically available’ in the 2010 Chapter IX of the OECD Transfer Pricing Guidelines) have to be considered.

In 2005, the Federal Tax Court confirmed the principles established in prior rulings that losses incurred by a distribution entity over a certain period trigger a rebuttable presumption that the transfer prices are not at arm’s length.

In a 2011 decision, the Federal Tax Court confirmed the statutory authority of the tax office to assess penalties between €2,500 and €250,000 in the event a taxpayer does not timely fulfil its cooperation duties (e.g., provision of records or documentation) in a tax audit.

In 2012, 2014 and 2015, the Federal Tax Court prescribed the prevalence of double-tax treaty rules over Section 1 FTA. In both decisions, the Federal Tax Court decided that based on double-tax treaty rules similar to Article 9 of the OECD Model Tax Convention, the arm’s-length analysis should be restricted to the testing of the transfer price applied by the parties involved. On 30 March 2016, the Federal Ministry of Finance issued a ‘non-application decree’ stating that Article 9 of the OECD Model Tax Convention does not refer to a transfer price adjustment but to a profit adjustment instead.

16 K 1053/11 E.
17 IR 22/14.
18 IR 103/00.
19 IR 87/02.
20 IR 22/04.
21 XB 37/11.
22 IR 75/11, IR 23/13 and IR 29/14 respectively.
In 2013,\(^{23}\) the Federal Tax Court ruled that the obligation to prepare, and upon request submit, transfer pricing documentation is in line with EU law. In particular, these obligations do not breach the freedom of establishment.

In 2016,\(^{24}\) the Lower Tax Court of Münster confirmed that standard transfer pricing methods (CUP, resale minus, cost-plus) are, in general, equal to one another. It is up to the taxpayer and the German tax authorities to determine the most appropriate method for each individual case. To determine arm's-length interest rates on loans within the group, according to the court's assessment of the case, cost-plus shall be the best method. This ruling is currently subject to revision by the Federal Tax Court.

In 2016,\(^{25}\) the Lower Tax Court of Cologne confirmed its position that an EU Member State's requests to another Member State for administrative assistance is in line with the law if the requested information is foreseeably relevant to the administration and enforcement of the domestic laws of the requesting Member State. The Lower Tax Court further clarified that 'foreseeably relevant' means that at the time of the request there was a reasonable possibility that the requested information could be relevant for tax purposes. The standards recognised by the Lower Tax Court are very low and therefore nearly anything could be deemed foreseeably relevant.

In 2017,\(^{26}\) the Lower Tax Court of Cologne confirmed that loans can be secured through guarantees between affiliated entities. The guarantee fee can be determined by application of the CUP method. Furthermore, the Court accepted interest rates determined from bank loans as comparable data for determining an appropriate interest rate for inter-company loans.

On 31 May 2018, the ECJ ruling in C-382/16, *Hornbach* considered the compatibility of Section 1 of the Foreign Tax Act (AStG) with European law. Although Section 1 AStG restricts the freedom of establishment, it is not contrary to European law if the taxpayer is given the opportunity to present 'economic reasons' justifying transfer prices deviating from the arm's-length principle. In this context, the Federal Ministry of Finance published new administrative regulations\(^{27}\) on the application of the ECJ judgment in the *Hornbach* case. These regulations restrict the criterion of economic reasons to actions related to near insolvency situations. The taxpayer must in particular prove the related party's or the group's need and capability for recovery. The regulations are effective as from 6 December 2018 and apply to all open cases.

In 2018,\(^{28}\) the Federal Tax Court ruled that an agreement between an entity and its shareholder that specifies neither the ‘whether’ and ‘how’ nor ‘at which point in time’ the contractual services are provided does not comply with the arm’s-length standard. Although the case concerned was domestic in nature, the principles should apply for cross-border arrangements as well. It is noteworthy that the Federal Tax Court did not rely on its principles according to which a deemed dividend may also be presumed to exist if an entity provides a service to a controlling shareholder without a clear, prior, legally effective and actually conducted agreement.

\(^{23}\) I R 45/11.
\(^{24}\) 13 K 4037/13 K F .
\(^{25}\) 2 V 2498/16.
\(^{26}\) 13 K 2302/14.
\(^{27}\) IV B 5 – S 1341/11/10004-09 dated 6 December 2018.
\(^{28}\) I R 77/16.
In 2018, the Federal Tax Court ruled that tax audit inquiries, even when qualified as ‘mere administrative actions’, could be appealed in court if the tax authorities have formally declined an objection.

Currently, pending transfer pricing disputes include both procedural and substantive issues, including the following:

- the valuation of IP post-acquisition (purchase price allocation); and
- exit tax or transfer of functions of a production ‘function’.

### VIII SECONDARY ADJUSTMENT AND PENALTIES

The following penalties for the provision of transfer pricing documentation apply alternatively. They apply both to master files and local files:

- If the file is not submitted or is ‘essentially unusable’, German regulations establish the rebuttable presumption that the income of the German entity has been under-reported and allow German tax authorities to rely on estimated figures and adjust transfer prices at the upper end of the arm’s-length range. Further, the tax authorities impose a penalty amounting to at least five per cent, but not exceeding 10 per cent of the income adjustment. The minimum penalty amounts to €5,000.

- If the file is essentially usable but submitted late, tax authorities may impose late fees or penalties of up to €1 million with a minimum penalty of €100 for each late day after the due date. Penalties may be waived if the taxpayer is not responsible (or has only limited responsibility) for the lack of appropriate documentation. Separate penalties may be imposed if the taxpayer fails to submit the CbCR at all or on time, or in the event the CbCR is deemed insufficient. Penalties may amount to up to €10,000.

Where adjustments result in an increased tax burden, non-deductible interest will be assessed at a rate of 6 per cent per annum for the period commencing 15 months after the end of the calendar year in which the tax liability arose.

The interest rate of 6 per cent per annum is currently under review by the German Constitutional Court.

### IX BROADER TAXATION ISSUES

#### i Diverted profits tax and other supplementary measures

A diverted profits tax is not applicable under German domestic tax law.

#### ii Double taxation

The EU Arbitration Convention is a potentially useful mechanism to avoid double taxation within the EU. It is also a helpful argument in the course of negotiations with the tax auditors. The Federal Central Tax Office as competent authority has issued administrative regulations offering guidance on both the MAP and the procedure under the EU Arbitration Convention, and which clarify existing practices and the approach of the Federal Central Tax Office in these matters.
After Brexit, the EU Arbitration Convention will continue to apply with regard to the United Kingdom, even if the United Kingdom were to withdraw from the EU without a withdrawal agreement (‘hard Brexit’). The EU Arbitration Convention is a contract subject to international law and therefore independent of both European law and the United Kingdom’s status as a Member State of the EU.

If the transfer pricing adjustment leading to double taxation has been initiated by the Federal Central Tax Office, for example, as a result of a transfer pricing audit, the taxpayer may also file a protective action with the local tax court. Usually, legal proceedings can be suspended until after the conclusion of the MAP.

On 3 November 2017, the EU Tax Dispute Resolution Directive entered into force. It shall be adopted into domestic law by 30 June 2019. The mandatory dispute resolution rules apply to any double taxation of profits arising as of 1 January 2018. The new dispute resolution mechanisms shall be based on the EU Arbitration Convention and extend its scope beyond transfer pricing disputes. The directive is of particular interest in cases where it is in dispute whether local activities from a permanent establishment are for the benefit of the non-resident entity.

iii Consequential impact for other taxes
In practice, transfer price adjustments generally neither affect value added tax nor import and customs duties. At the same time, it has become more common for customs auditors to refer to transfer pricing documentation in their investigation.

X OUTLOOK AND CONCLUSIONS
German tax and transfer pricing law has been complex and rich in detail for some time. Current and future measures of anti-tax avoidance will create further complexities and uncertainties in interpretation. Aggressive audit scrutiny and proposed adjustments of transfer prices will likely continue to rise. Factual representations in audit may meet with considerable scepticism. Strong factual documentation as well as precautionary monitoring of compliance with transfer price policies are cornerstones of audit defence. In view of the growing intensity and size of transfer price disputes, knowledge of their procedural specifics becomes vital for successful defence. Tax controversies and tax litigation concerning transfer pricing are becoming more frequent and often involve amounts of more than €100 million in adjustments. Transfer price planning continues to be possible but requires a greater degree of interaction between the in-house tax function and other business functions, and a higher level of preparatory analysis.
Appendix 1

ABOUT THE AUTHORS

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Dr Stephan Schnorberger is a tax partner and principal economist with the Düsseldorf office of Baker McKenzie. He works for international businesses to facilitate cross-border activities in today’s tax environment and to advocate and defend the rule of law in transfer price disputes. Stephan also supports businesses through economic analysis and advocacy in competition matters such as business combinations, cartel damage cases and questions of abuse of a dominant market position. For many years, Stephan has been recognised as one of the world’s top tax advisers in Euromoney Legal Media Group’s _Expert Guides: The Best of the Best_ and _Expert Guides: Transfer Pricing_.

His practice focuses on transfer pricing, business restructuring, supply chain modelling, international tax planning, high-value audit defences, complex tax litigation, and competition and regulatory economics. As a certified tax adviser, Dr Schnorberger has been admitted to the German tax bar. He holds a German doctoral degree and a master’s degree in business administration, as well as a US master’s degree in economics. Stephan is a member of the German Association of Tax Advisers and a member of the International Fiscal Association.

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Rabea Lingier is an associate at Baker McKenzie, based in Düsseldorf. She specialises in transfer pricing, reorganisations and supply chain transformations for multinationals, and has particular expertise in the taxation of permanent establishments. Her practice focuses on defending transfer price regimes in tax audits and court proceedings, and in mutual agreement and arbitration procedures, advance pricing agreements and tax rulings. As a certified tax adviser, Rabea Lingier has been admitted to the German tax bar.

She obtained her Master of Laws from Maastricht University in the Netherlands. Before joining the firm in 2016, she worked in the international tax and transfer pricing team at a Big Four accounting firm.
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