



## TP Perspective – Newsflash

Dear Reader,

On May 7, 2021, the German Parliament (Bundestag) adopted the “*Gesetz zur Modernisierung der Entlastung von Abzugsteuern und der Bescheinigung von Kapitalertragsteuer - AbzStEntlModG*” (Act to modernize the relief from withholding taxes and the certification of capital gains tax). The German Federal Council (Bundesrat) has passed the Act on May 28, 2021 so that the German legislative process is now finalized.

The Act also contains amendments or supplements to the Foreign Tax Act (AStG) and the General Tax Code (AO) that are relevant from a transfer pricing perspective. These were already included in similar form in the draft bill for the ATAD Implementation Act (“ATADUmsG”) published by the German Federal Ministry of Finance (“BMF”) on December 10, 2019 and March 24, 2020, respectively, which, however, has not yet been adopted into German law.

The Act addresses key contents of BEPS action points 8-10 (“*Aligning Transfer Pricing Outcomes with Value Creation*”). For example, the Act contains a comprehensive revision and new version of Section 1 of the German Foreign Tax Act (AStG) and emphasizes, among other things, the substance over form approach envisaged by the OECD and the application of the OECD “DEMPE” concept in the context of intangibles. It should be mentioned that the German tax authorities assume that the DEMPE concept should have also applied according to German transfer regulations prior to the implementation of the Act and that the now revised version of Sec. 1 AStG only clarifies this. However, the Act does not include the controversial provisions from the Federal Ministry of Finance’s draft proposals for the ATADUmsG, which dealt with intra-group financing relationships. The proposed provisions of Sec. 90 (3) AO-draft version regarding master file documentation (i.e. reduction of the documentation threshold from EUR 100 m to EUR 50 m and prompt documentation requirement) were also not adopted.

In the following, a brief summary of the main changes introduced by the Act regarding the German transfer pricing regulations is given (in particular, the revision of sec. 1 AStG-new version (correction of income) including the newly introduced Sec. 1a AStG-new version (price adjustment clause), as well as the newly introduced Sec. 89a AO-new version on APAs are discussed in this Newsflash).

### **Amendments and additions to Section 1 AStG-new version (correction of income)**

Sec. 1(3) AStG-new version: Arm's length prices and choice of transfer pricing method

- For the first time the legal definition of arm's length prices is given as “*transfer prices in line with the arm's length principle*”.
- Referring to the time of the agreement on the transaction as the relevant date. The German federal government has made it clear that this should not be understood as an ex ante price-setting-approach.
- A move away from a hierarchy between transfer pricing methods (previously the standard methods, i.e. comparable uncontrolled pricing method, resale price method and cost-plus method took precedence), instead, in accordance with the OECD Transfer Pricing Guidelines 2017, the best method should be applied on a case-by-case basis depending on the data available (“best method rule”).

Sec. 1(3a) AStG-new version: Regulation on benchmark ranges in cases of limited comparability and hypothetical arm's length test

- Legal endorsement of the interquartile range as the arm's length range of prices in cases of limited comparability.
- Application of the median for values outside the interquartile range (escape clause: possibility for the taxpayer to provide evidence that another value is arm's length).
- In cases where the hypothetical arm's length test is applied, the mean of the range between the minimum price of the transferring entity and the maximum price of the recipient entity is applied in accordance with Sec. 1(3) sentence 7 AStG. The taxpayer has the possibility to provide evidence that another value in the range is arm's length.

Sec. 1(3b) AStG-new version (previously: Sec. 1(3) sentence 9 AStG): Transfer of functions (i.e. exit tax) regulations

- First legal definition of the concept "transfer package" is provided..
- Inclusion of escape clause for business restructurings involving the transfer of routine functions, which are also included in Sec. 2(2) sentence of the ordinance on the transfer of functions and in paragraph 66 et seqq. of the administrative principles on transfer of functions: Single valuation (instead of transfer package) in cases where the transferring entity provides evidence that only non-valuable intangibles are part of the transaction. This holds true if the function will be performed by the recipient entity only for the transferring entity and if the cost plus method is applied.
- The two other escape clauses which were part of Sec. 1(3) sentence 10 AStG are not included in Sec. 1(3b) AStG-new version and as such are no longer applicable: Second escape clause: The sum of the individual transfer prices, compared to the value of the transfer package as a whole, complies with the arm's length principle. Third escape clause: At least one essential intangible asset can be identified as part of the business restructuring.

Sec. 1 (3c) AStG-new version: Intangible assets

- First legal definition of intangible assets is provided.
- Incorporation of the DEMPE functions described in the OECD Transfer Pricing Guidelines 2017 (i.e. development, enhancement, maintenance, protection and exploitation of intangible assets) into domestic law as the basis for the identification of the economic owner and therefore allocation of income generated from intangible assets.
- The mere financing of DEMPE functions related to intangible assets justifies a remuneration of the financing function only. It does not entitle the financing company to the income stemming from the intangible asset as such.

## **Introduction of a new Sec. 1a AStG-new version (price adjustment clause)**

Sec. 1a AStG-new version (previously: Section 1(3) p. 11 AStG)

- The scope of the price adjustment clause will be extended to all transactions, which include material intangible assets or benefits (i.e. not only transfer of function provisions).
- Reduction of the adjustment period for transfer prices from ten to seven years, adjustment amount is accounted for in the eighth year.
- Adjustment of the transfer price in the event of a "substantial deviation" from the profit expectations on which the valuation has been based. A "substantial deviation" is defined as a deviation of more than 20% of the initial profit expectations.
- A price adjustment shall not be made in the following cases:
  - The development of the transfer price is based on circumstances that could not be taken into account ex-ante (i.e. at the time of the business transaction). Note that the burden of proof lies with the taxpayer,
  - Uncertainties about future developments were considered in the ex-ante determination of the transfer price (burden of proof again lies with the taxpayer),
  - Existing license agreements for intangible assets which are based on sales or profits.

## **Regulations on APAs in the new Sec.89a AO-new version**

- Creation of a separate domestic legal basis, not only for profit attribution cases, but also for all international cases where double taxation is foreseen.
- Restriction on facts and circumstances that are not yet realized, but the possibility of a roll-back within the framework of a mutual agreement procedure remains.
- Explicit regulation of procedural requirements:
  1. A risk of double taxation exists (i.e. exclusion of double non-taxation),
  2. The likelihood of the elimination of double taxation by the APA exists,
  3. The likelihood exists that a consistent interpretation of the APA with the competent authority of the other contracting state can be achieved.
- Furthermore, Sec.89a AO-new version among others provides details on the information to be included in an APA application and raises the fees for an APA application from EUR 20,000 to EUR 30,000 (the fees for the application for the extension of an existing APA remain at EUR 15,000).

### **Date of application and potential changes in ordinances**

Pursuant to Article 21 of the AbzStEntlModG, the Act enters into force on the day after its announcement, i.e. after being published in the German Federal Gazette (“Bundesanzeiger”). Regarding the amended and newly introduced Sec. 1 and Sec 1a AStG-new version, the rules apply to personal and corporate income tax from financial year 2022 onwards. With regard to the newly introduced Sec. 89a AO-new version, the regulations on APAs apply to applications submitted to the German Federal Central Tax Office (BZSt) after the date of announcement of the amended *Introductory Act to the General Tax Code* (EAO) (included in the new Section 34 EAO).

As a result of the changes in the German transfer pricing regulations, it is to be expected that there will be a fundamental revision of the relevant transfer pricing-specific ordinances (in particular the ordinance on the transfer of functions and the ordinance on the documentation of profit allocations) as well as the relevant administrative instructions (e.g. Administrative Principles on Transfer of Functions). The relevant authorizations with regard to Section 1 AStG are included in Section 1 (6) AStG-new version of the Act. In this context, the Federal Ministry of Finance already published new Administrative Principles 2020 on December 3, 2020 regarding transfer pricing-specific topics (including cooperation and documentation obligations of the parties involved, as well as the authorization of the tax authorities to estimate the tax base).

### **Outlook**

The changes to the German transfer pricing regulations within the framework of the AbzStEntlModG will result in significant changes and additional requirements for taxpayers. Even though the amended and newly introduced Sec. 1 and Sec 1a AStG-new version will only apply from financial year 2022 onwards, it is highly advisable that taxpayers become familiar with the changes and analyze their transfer pricing systems against the substance over form approach envisaged by the OECD, as well as the DEMPE-functions performed in connection with valuable intangibles. The DEMPE analysis should receive particular attention because prior to the implementation of the AbzStEntlModG, the German tax authorities only assumed that the DEMPE analysis should be applicable according to German transfer pricing regulations, however this has now become binding law following Sec. 1(3c) AStG-new version (i.e. the German tax authorities now also have a formal legal basis for the DEMPE analysis).