TP Perspectives - Newsflash

New "Administrative Principles Transfer Pricing - Principles for the Adjustment of Income Pursuant to Section 1 of the External Tax Relations Act ("AStG")".

Dear readers,

On 6 June 2023, the Federal Ministry of Finance (hereinafter: "BMF") published its **new principles for the correction of income pursuant to Section 1 AStG** (hereinafter: **VWG 2023**) on its website. These are to be applied to all open cases with immediate effect. Only the chapter on relocation of functions is applicable to cases that are realised after 31 December 2021. The BMF letter of 13 October 2010 continues to apply to cases realised before that date.

I. Overview:

In the VWG 2023, the tax authorities have updated their view on **intra-group relocations of functions** and **financial transactions** and illustrated it with examples. The other chapters remain largely unchanged, apart from editorial changes.

II. Background:

The revision of the Administrative Principles was in particular necessary due to the **amendments to Section 1 AStG that have been made in the meantime** and the **revision of the Business Function Relocation Ordinance** (hereinafter: "FVerlV") of 18 October 2022 (BGBl I p. 1803). In addition, in the course of the revision, the **case law of the German Federal Fiscal Court (hereinafter: "BFH") on the determination of arm's length interest on loans** (BFH of 18 May 2021, I R 4/17, BFH of 18 May 2021, I R 62/17) and **on partial write-downs of unsecured loans granted within a group** (BFH of 27 February 2019, I R 81/17; BFH of 9 June 2021, I R 32/17; BFH of 13 January 2022, I R 15/21) was also included in the VWG 2023 . All judgments should be published in the Federal Tax Gazette (hereinafter: "BStBl.") in a timely manner.

In the following, the structure and essential new content of the VWG 2023 are presented and explained:

III. Structure and scope:

With over **800 pages,** the VWG 2023 appear at first glance to be significantly more extensive than the previous version from 2021, which only comprised 46 pages. However, a closer look shows that the larger volume of the VWG 2023 is mainly due to the fact that the OECD Transfer Pricing Guidelines 2022 (German version), attached as Annex 1, are included within this page count. In Annex 2, the VWG 2023 now contain a glossary. Furthermore, the VWG 2023 have been extended by an additional Annex 3, which contains many **helpful examples** for the application of cross-border **relocations of functions**.

The Administrative Principles Transfer Pricing are generally structured and also numbered in such a way that they can be adapted to current developments at any time. Accordingly, nothing has changed in the **chapter structure** (I-VI) compared to the VWG 2021.

IV. Key aspects of content:

In the following, the most important content, as well as the changes and additions within Chapter III of the VWG 2023, are outlined in more detail.

Section A

It is positive that the VWG 2023, in paragraph 3.3, continue to explicitly state that the **arm's length principle** is to be **applied uniformly for both inbound and outbound cases**.

In addition, it is positive to note that according to the VWG 2023, the purpose of transfer pricing and audits should continue to be (as it was under the VWG 2021) to **allocate an appropriate share of the group's overall profit to the individual enterprise** (para. 3.7). Accordingly, the VWG 2023 focus on the **totality of business transactions** (para. 3.23) and less on whether individual products/services within a portfolio are profitable.

Section D: Administrative approaches to avoid and resolve transfer pricing conflicts

In **section D** (para. 3.45), reference is made to the updated information sheet on international **mutual agreement procedures dated 27 August 2021** (BStBl. 2021 I p. 1495) as well as to the **information sheet on coordinated external tax audits** with tax administrations of other states dated 9 January 2017 (BStBl. 2017 I p. 89).

The reference to the information sheet for bilateral or multilateral prior approval procedures (BMF letter dated 5 October 2006, BStBl. I p. 594) has been deleted.

Section I: Relocation of functions

The most adjustments overall within the VWG 2023 relate to **relocations of functions** (para. 3.87 - 3.120). This is not surprising, as the FVerlV was revised at the end of 2022 as a result of the amendments to Section 1 AStG. Accordingly, the structure of Section I corresponds overall to the structure of the new FVerlV. The VWG 2023 contain many examples, which should make it easier for the taxpayer to apply the statutory rules regarding relocations of functions. In addition to the examples, the VWG 2023 also explain in which constellations the tax authorities should assume a relocation of functions and under which conditions this is not the case (para. 3.91 - 3.93).

It would have been desirable to clarify that the mere sale or **relocation of use of** assets or the **provision of services does not constitute a relocation of functions**. In Section 1 (7) of the old FVerlV, this was still expressly regulated in this way, but this paragraph has been omitted in the new version of the regulation.

The **opportunity** was also **missed to** clarify in the VWG 2023 that **no total valuation based on the capitalised earnings value (transfer package valuation), but only an individual valuation for transferred/transferred assets, is** to be carried out if **only routine functions** are **transferred** (cf. Section 2 (2) FVerlV old version). However, this should arise out of the opening clause of Section 1 (3b) sentence 2 AStG, according to which an individual asset valuation is permissible if neither significant intangible assets nor other benefits are the subject of the relocation of functions.

Section 4 (2) FVerlV old version still contained a simplification rule to the effect that in cases where - e.g. due to the lack of existing contractual regulations - it was doubtful whether functions were only transferred for use or were transferred, a **transfer of use** was to be assumed at the request of the taxpayer. This was intended to avoid taxation conflicts with foreign tax authorities. Unfortunately, this simplification rule has not been adopted in the new version of the FVerlV. The new VWG 2023 do not address this issue. Nevertheless, a transfer of use can at least be assumed if retention of beneficial ownership can be pre-supposed due to the civil law structure and the actual circumstances.

The VWG 2023 also contain **guidelines** on how taxpayers should handle cases where **personnel** of a transferring company work for the receiving company in direct economic connection with a relocation of functions (para. 3.94) and how **cases of personnel secondment in** the context of a relocation of functions are to be classified (para. 3.95). However, a clearer distinction would have been desirable between cases of pure service provisions or temporary secondments/assignments of staff on the one hand and permanent transfers of staff on the other. In our opinion, the former should not normally fulfil the requirements of a relocation of functions. Further, it cannot be assumed across the board that the transfer of staff always involves the transfer of intangible assets or other advantages. This should not be the case, for example, with purely routine functions or (publicly accessible) know-how that is customary in the industry. In addition, a transfer or secondment of an individual employee between associated

enterprises should not normally require additional remuneration (para. 1.174 OECD Transfer Pricing Guidelines 2022). This also follows from subs. 4.2 of the Administrative Principles on the Posting of Workers[1], according to which the mere work undertaken by seconded employees and the expertise they provide is part of and the reason for the secondment, therefore usually not requiring separate remuneration.

With regard to the **opening clause** for the **valuation of individual assets** in section 1 (3b) sentence 2 AStG, paragraph 3.97 of the VWG 2023 clarifies that intangible assets are to be considered material if they are necessary for the transferred function (**qualitative** criterion) and their arm's length price amounts to more than 25 per cent of the sum of the individual prices of all assets of the transfer package (**quantitative** criterion). In principle, this is in line with the previous administrative opinion. However, with regard to the quantitative criterion it also requires a transfer package valuation if only insignificant intangible assets are transferred. A simplification rule for such cases (e.g. transfer of routine functions) would have been preferable. In addition, the opening clause of section 1 (3b) sentence 2 AStG should not be applicable if an "other advantage" is part of the transfer package. However, there is legal uncertainty in this regard, because neither the law nor the regulation nor the VWG 2023 contain a definition of this term.

According to paragraph 3.99 of the VWG 2023, **no** relocation of functions is to be assumed in cases of a **duplication of functions.** An example of this is the commencement of production abroad, provided that the previous production and sales activities of the domestic company are carried out unchanged. However, the previous de minimis limit, according to which a decrease in turnover of the transferring company of less than EUR 1 million should not be assumed to be a relocation of functions, was unfortunately not adopted in the VWG 2023. In addition, according to the tax authorities, a **relocation of functions should** also be assumed in cases where one function is **substituted** by another. Example b contained in paragraph 3.99 makes it clear that this applies even if there is no staff reduction in Germany and a higher turnover is achieved through the new function (e.g. the manufacture of a new product). Whether in such constellations a third party would always be willing to pay remuneration is doubtful. These doubts are justified - especially with regard to the judgment of the Munich Tax Court of 26 November 2019[2] and the judgment of the European Court of Justice in the "Hornbach" case of 21 January 2010[3] - in particular if the function has previously led to **losses** at the domestic company and there are thus **business reasons** for the relocation. If the tax authorities assume a relocation of a function in cases of a substitution of a function by another more profitable function, the question arises whether (in the absence of a transfer of material intangible assets) the scope of application of the opening clause in section 1 (3b) sentence 2 AStG is fulfilled or whether a compensation claim appears appropriate, even if a transfer package valuation is carried out (in particular if, from the perspective of the transferring company, the profits after the transfer are higher than the profits before the transfer).

The question of whether the relocation of a production function that is not carried out vis-à-vis external companies, but exclusively vis-à-vis group companies, is to be regarded as a relocation of functions or transfer of business opportunities - and therefore must be remunerated - has been a highly contentious topic until now. The Lower Saxony Tax Court denied this in a sensational judgment of 16.03.2023 (Ref.: 10 K 310/19). In this judgment, the Tax Court justified this by stating that the production profits had arisen from the allocation of orders by the parent company, without the domestic production company having a legal claim to retain the order quantity. Rather, the allocation of orders had always been at the discretion of the group's top management, which also had the valuable market positions (supply contracts with third parties). In this context, the Tax Court also clarified, in accordance with the definition in section 1 (2) of the FVerlV, that there is no relocation of functions if neither economic assets nor other advantages or business opportunities are transferred, nor there is a causal link between the transfer of advantages in the broadest sense and the transfer of the ability to perform a function.

With regard to the **area of agreement** (so-called “Einigungsbereich” in German usage), i.e. how the arm's length principle is to be applied if this leads to a **range of values**, there are several **examples** in a separate annex to the VWG 2023 (Annex 3) that show on the basis of concrete figures how the

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1 Cf. BMF v. 9.11.2001 - IV B 4 - S 1341 - 20/01, BStBl. 2001 I, 796.

2 Cf. FG Munich of 26 November 2019 - 6 K 1918/16, EFG 2020 p. 764.

3 Cf. ECJ of 21.01.2010 - Case C-311/08, "Hornbach", IStR 2018 p. 461.

"Einigungsbereich" is to be determined for different case constellations. In the examples of the tax authorities, the effects on the capitalised earnings value in the determination of the **minimum and maximum price** are specifically explained in the case where the relocation of functions entails **synergy and tax effects** and in the case where there are **limited capitalisation periods.** However, with regard to the capitalisation period, there are **no indications** in the VWG 2023 as to how exactly the **"proof"** required in section 5 FVerlV is to be provided that this is not unlimited, but rather limited to a restricted period. It may be doubted that third parties regularly assume an unlimited term in the context of the purchase price determination. In another example of the tax authorities, it also becomes clear how important it is for taxpayers to **agree on price adjustment clauses** when it comes to transfers of functions involving significant intangible assets or other advantages. This is the only way to **prevent** income corrections in subsequent audits.

Paragraph 3.102 explains that elements of **actual arm's length behaviour** may have to be taken into account in the **hypothetical arm's length comparison.** This applies, for example, if an internal calculation or costing scheme is used in comparable situations by taxpayers both vis-à-vis related companies and third parties. The tax authorities cite as an example a licensing system linked to the expected income of the licensee. However, according to the tax authorities, this in no way means that licence rates can be derived from databases in a hypothetical arm's length comparison. This **blanket rejection of conducting** an external price comparison on the basis of so-called "**benchmarking studies**" should be viewed critically and is **not in line with the OECD Transfer Pricing Guidelines 2022**. In particular, for pricing individual components of the transfer package, helpful information can be obtained from such database studies (that have recourse to publicly available market data).

Paragraph 3.106 states that the **appropriate capitalisation rate** should be the return on an alternative investment equivalent to the valuation object in terms of maturity, risk and taxation, whereby this can be the **return on equity** or the **return on equity and debt capital** (weighted average cost of capital, "WACC"), depending on the choice of the specific valuation method. The calculation should be made by means of the so-called "risk mark-up method", which should be identical in content to the Capital Asset Pricing Model ("CAPM" method) commonly used in practice. For the period of a perpetuity, a growth discount should be taken into account in the capitalisation interest rate. Also welcome and in line with common practice is the simplification rule contained in paragraph 3.110 that, for reasons of simplification, a **uniform capitalisation period** can be assumed for both the transferring and the acquiring company.

Noteworthy are the remarks in paragraph 3.107 f., according to which, especially in cases of a **downsizing of functions, termination probabilities** for routine functions remaining in Germany should also be taken into account within the framework of the assessment (if necessary, by means of a scenario analysis).

Finally, it should also be noted that the provision contained in subs. 1.1 no. 3 of the Administrative Principles on the Relocation of Functions[4] **that the standards** on the relocation of functions should also be applicable analogously in **inbound cases** was **not** adopted in the VWG 2023. Against the background of the **principle of equality** (Art. 3 (1) German Basis Law and para. 85 German tax code) and para. 3.3 of the VWG 2023 - according to which the arm's length principle is to be applied uniformly for inbound and outbound cases - this should not however result in any deviating treatment in practice.

Section J: Financing relationships

In **Section J** (para. 3.121 - 3.135), which deals with **financing relationships** in more detail, the **case law of the BFH** on the determination of arm's length **loan interest** on group loans (para. 3.125 - 3.126) and on the profit-reducing derecognition of **unsecured loan receivables** (para. 3.128) was included (BFH of 18 May 2021, I R 4/17 and of 13 January 2022, I R 15/21). Thus, with regard to the interest rate on loans, the tax authorities maintain in particular that (foreign) financing companies that **cannot** independently **control the risk** of group financing may only demand a **risk-free return** for the provision of capital. The statements of the tax authorities in paragraph 3.125 VWG 2023, according to which foreign financing companies that cannot independently control and bear the risk of loan

[4] Cf. Principles for the Examination of the deferral of income between related parties in cases of cross-border relocation of functions of 13 October 2010, IV B 5 - S 1341/08/10003.

defaults should only be entitled to a risk-free return, are open to criticism. The statements contradict both the BFH judgment of 18.5.2021 (I R 4/17), which is now cited in the VWG 2023, and the OECD Transfer Pricing Guidelines 2022. At least there is convergence with the BFH and the OECD Transfer Pricing Guidelines 2022 to the extent that in the event that there is a grant of a loan without the associated risks differ, it must be examined whether there are further transactions between the lender and the company that actually controls and bears the risks (e.g. parent company).

With regard to **interest rates on loans**, the previous statements on the absence of interest or lower interest rates in the context of a required injection of equity have also been **removed** in the VWG 2023 (para. 3.93 VWG 2021), according to which it was sometimes possible to dispense with a required objection in this constellation during an audit. With regard to collateralisation, the adoption of the principles of case law once again makes it clear that the tax authorities have now **clearly** acknowledged that both **collateralisation and non-collateralisation of loans can be at arm's length,** which was previously only possible in individual cases with regard to unsecured loans in accordance with the VWG 2021.

The VWG 2023 **newly** include the aspect - which companies should be keeping an eye on - that the extent and the effects of a **knowledge advantage** resulting from the **corporate links** must be taken into account appropriately in each individual case (para. 3.127), although the tax authorities unfortunately **do not further specify** this aspect in their explanations. Also newly added to the general considerations on financing relationships are the comments on **alternative courses of action**, insofar as these are available to related parties and have led to advantageous conditions for debtors (para. 3.128), which legal practitioners should also take into account.

Section L: Price adjustment clause

The VWG 2023 also explicitly address **price adjustment clauses** in **Section L** (para. 3.136) and stipulate that in cases where a proper price adjustment clause has been contractually agreed, the application of section 1a AStG is excluded. However, this should already follow directly from the wording of the law and is therefore rather declaratory.

Repeal of Administrative Regulations and date of application (para. 6.1 - 6.3):

In principle, the **VWG 2023** are to be **applied retroactively to all open cases**, although the statements on relocation of functions contained in Chapter I are to be applied to such relocations of functions that were realised after 31 December 2021 in accordance with the new FVerlV as of 1 January 2022.

With the publication of the VWG 2023 in the BStBl., the **VWG 2021** of 14 July 2021 and the **non-application decree of 30 March 2016 on the two BFH judgments I R 23/13 and I R 29/14** will be **repealed**. In its judgment of 11 October 2012 (BStBl. 2013 II p. 1046), the BFH had decided that Art. 9 OECD-MA (or the respective DTA modelled on it) defines the framework for profit adjustments that may have to be made and possibly blocks further, domestically permissible adjustment options of a state. In the case of the judgment, the BFH came to the conclusion that the hidden profit distribution assumed by the tax audit, which was based on a violation by the company of the **prohibition of retroactivity,** failed due to the blocking effect of the DTAs. Subsequently, it was disputed whether the blocking effect only affects the amount of a transfer pricing correction or also corrections on the merits (e.g. correction of partial write-downs of intercompany loans pursuant to section 1 AStG). The BFH had initially ruled in two judgments, which were confirmed by the BMF with a non-application decree, that the blocking effect also extends to the correction on the merits. Thus, according to the BFH, a correction of partial write-downs of intercompany loans pursuant to section 1 AStG failed due to the blocking effect. In its judgment of 27 February 2019 (I R 73/16 BStBl 2019 II p. 394), the BFH then changed its previous case law and now ruled that Art. 9 para. 1 OECD-MA does not extend the correction scope of **sec. 1 para. 1 AStG is not** limited to transfer price adjustments in terms of amount, but also allows the neutralisation of a profit-reducing derecognition of a loan receivable or a partial write-off thereof pursuant to section 1 AStG (contrary to the previous BFH judgments of 24 June 2015, BStBl II 2016, 258, and of 17 December 2014, BStBl II 2016, 261). Since the new BFH case law was incorporated and cited in paragraph 1.5 of the VWG 2023, the non-application decree on the BFH rulings from 2014 and 2015 had become obsolete and was therefore now repealed (para. 6.1 VWG 2023).

V. Conclusion and Outlook:

We **recommend that taxpayers deal with the VWG 2023 in detail** in a timely manner, as they are to be applied in principle to **all open cases.** This is particularly important in the light of the fact that current tax audits with assessment periods prior to 2023 or, with regard to relocations of functions, with assessment periods after 2021, could also be affected by the principles contained in the VWG 2023. In particular, the new regulations in the FVerlV of 18 October 2022 are explained in the VWG 2023 and illustrated by means of practical examples. However, since in this context the tax authorities have supplemented their explanations with examples and clarifying explanations, it remains to be analysed on a case-by-case basis whether these will contribute to more legal certainty in the future.

The new VWG 2023 also contain revisions with regard to **financing relationships.** In that context, **it is to be welcomed** that the tax authorities have clearly acknowledged that both **collateralisation** and **non-collateralisation of** loans can be **compliant with the arm's length principle** by adopting the BFH case law principles, some of which have not yet been published in the Federal Tax Gazette. In our opinion, the equal treatment with regard to the collateralisation aspect could contribute to more legal certainty overall, so that in the future the discussions in tax audits should hopefully be reduced.