TP Perspective - Newsflash

Dear Readers,

on December 4th, 2020, the Federal Ministry of Finance ("BMF") published the new **2020 Administrative Principles** on its homepage[1] (IV B 5 - p 1341/19/10018 :001). These are to be applied with immediate effect by the German tax authorities. Even though the 2020 Administrative Principles are not legally binding for courts and taxpayers, they nevertheless contain many practically relevant hints for taxpayers, in particular when preparing for future tax audits.

The main focus of the 2020 Administrative Principles circles around the application of sections 90 of the German Fiscal Code ("**AO**") (regarding the involved parties' obligation to cooperate) and 162 AO (estimation of tax bases). Throughout the 25 pages of the 2020 Administrative Principles, the position of the tax authorities regarding the obligation to cooperate in general, the principles of the requirement to keep records, the requirements for documentation of the factual circumstances and documentation regarding the appropriateness of transfer prices, as well as on the potential estimation of tax bases is explained in detail. While the sections 1 through 66 of the 2020 Administrative Principles deal with the involved parties' obligation to cooperate (section 90 AO), the following sections 67 through 90 deal with the estimation of tax bases and penal surcharges (section 162 AO). Finally, the Administration Principles deal with the substitution of (part of) the existing administrative regulations in section 91.

The following is a brief overview of the main contents of the 2020 Administrative Principles.

General information on the duty to cooperate (sections 1 through 8)

Introduction (sections 1 through 4)

The taxpayer is generally obliged - without request of the tax authorities - to cooperate in the process of fact finding and clarification. This general obligation as stipulated in section 90 para 1 AO is further specified and extended in following sections of the AO, such as in section 90 para 3 AO for the documentation requirements, section 147 AO for the access to electronic data or section 200 AO for obligations within a tax audit.

Authorized representative (section 6)

In the case of the appointment of an "authorized representative", the tax authorities should contact such person and only approach the taxpayer directly in exceptional cases.

Relief from obligations (sections7 and 8)

There is no "right to refuse to cooperate" for the direct parties involved, i.e. the taxpayer and the authorized representative. Also, the initiation of a mutual agreement proceeding in the course of an audit does not release the parties involved from their obligations to cooperate in accordance with section 90 AO.

[1] Can be seen at https://www.bundesfinanzministerium.de/Content/DE/Downloads/BMF_Schreiben/Weitere_Steuerthemen/Abgabenordnung/2020-12-03-Verwaltungsgrundsaetze-2020.pdf?__blob=publicationFile&v=2, last accessed on the 7th of December 2020.

Increased duty to cooperate in international matters - section 90 (2) AO (sections 9 through 24)

Effect in favor / disadvantage (section 9)

Especially in international matters it is the duty of the parties involved to produce all evidence required to fully clarify the respective issue. The tax authorities also state that this increased duty to cooperate in accordance with section 90 (2) AO applies whether or not the individual circumstances and facts are favorable or unfavorable for the party involved.

Evidence (sections 12 and 13)

According to the tax authorities, it is not sufficient to merely point out and name the evidence that is available abroad. The parties need to take every step possible to access the evidence. However, the increased obligation to cooperate in the clarification of foreign facts is limited by the principle of proportionality.

In addition, the tax authorities have significantly expanded the type and amount of evidence to be provided: In addition to expert opinions and statements relevant to transfer pricing, the obligation to submit evidence also extends to "emails, messenger service messages or messages by means of other electronic communication media, insofar as these comprise of business related content with a tax reference and are therefore to be considered as commercial or business letters".

Practical experience in tax audits has shown that the tax authorities have already been requesting mass data such as comprehensive email correspondence, whereby the admissibility of such requests has regularly led to discussions.[2]

Obligation to preserve evidence (section 14)

In this section the tax authorities provide a clarification as to which precautions have to be taken to ensure that evidence in cases relating to foreign matters is and remains available to the German authorities. This applies especially to cases where evidence, which is a necessary prerequisite for the examination of the appropriateness of the transfer prices, is located abroad.

In the 2020 Administrative Principles, the tax authorities also slightly adapt the list of examples as provided in the 2005 Administrative Principles Procedures **("VWG-Verf.")**[3], which outline the particular cases when a "prudent manager" would contractually reserve the right to receive documents from the other contracting party:

- Evidence of the third party sales prices when applying the resale price method.
- Specification of the example with regard to the cost-base of service providers (i.e. "calculation documents" instead of "invoices" are to be provided).
- Modified example regarding the proof of amounts paid in cost allocation agreements.
- The examples regarding royalty structures and the proof of third party revenue.
- Evidence on the overall profit or loss situation and the applied allocation key when applying a transactional profit split.

[2] See for discussion: Haselmann/Berger in IWB 01/2020, p.21.
[3] Federal Ministry for Finance of 12 April 2005 - IV B 4 – p 1341 - 1/05, Principles for the examination income allocation between related parties with cross-border business relations with reference to the duties of determination and cooperation, adjustments, as well as mutual agreement and EU arbitration proceedings (Transfer Pricing Documentation and Procedural Regulations dated April 12, 2005), BStBl. I, p. 570.

With regard to the obligation to provide such evidence, there is still room for discussion as to whether, for example, an external third party service provider would in practice disclose its internal cost calculation to its recipient (e.g. hourly wages of the employees involved broken down by individual projects or explicit allocation of overhead costs).

Dual or multiple roles (section 17)

When the same natural person is acting as managing director for more than one affiliated entity, the tax authorities assume that this person has a genuine possibility to retrieve and therefore provide information of such affiliated entities. It cannot be claimed that such information is unavailable.

Conflict of obligations (sections 18 and 19)

Further, in the case that "providing certain information to the authorities is inadmissible or punishable according to the regulations of other states", the tax authorities take the view that "this prohibition does not release the involved party from its obligation to cooperate according to section 90 (2) AO". The resulting "collision of obligations" is to be taken into account by the tax authorities in the context of estimating the tax base.

Nevertheless, the tax authorities reserve the right to take foreign law into account, to interpret contracts or similar documents or to make a corresponding assessment.

Special obligations to cooperate - section 90 (3) AO (sections 25 through 66)

Principle (sections 25 and 26)

With regard to general principles of the obligation to keep records, the tax authorities refer, among other things to GAufzV and Appendices I and II to Chapter V of the OECD Transfer Pricing Guidelines 2017.

Scope of application (sections 28 and 29)

With regard to the general scope of application, the reference in the existing VWG-Verf. that business relationships can also exist if there is no exchange of services, as in the case of allocations by way of cost sharing and cases of international employee assignments, is left out in the new wording. Also, agreements under corporate law (e.g. capital contributions) are still not part of the business relationships. In order for the tax authorities to be able to check whether an arrangement is caused by shareholding or actually stipulates a business relationship, the taxpayer must now, however, provide appropriate documents from all parties involved (e.g. balance sheets).

The statement of the tax authorities from the VWG-Verf. "assuming the existence of a business relationship does not depend on whether an appropriate remuneration, an unappropriate remuneration or no remuneration has been agreed upon based on the contractual relationship" is no longer applicable.

Permanent establishments (sections 30 and 31)

Regarding permanent establishments, the tax authorities clarify that the obligation to keep records according to section 90 (3) AO does not replace the obligation to prepare an auxiliary and supporting calculation according to section 3 of the Ordinance on the allocation of profits of permanent establishments - Betriebsstättengewinnaufteilungsverordnung ("**BsGaV**") and vice versa.

Language of the documentation (sections 32 through 34)

Documentation generally has to be presented in German language. By means of application the documentation may also be presented in another language (especially in English language). Such application can be filed before the documentation is prepared, but must be filed at the latest when the documentation is requested by the audit. However, such application shall only be granted under the precondition that requested translations will be presented in due course.

Ex-ante or price setting approach (sections 35 through 49)

For the preparation of transfer pricing documentation, the circumstances at the time when the transfer price was determined or the contract for the business transaction was concluded respectively amended or terminated are relevant. The form of the contract is irrelevant in this respect. By specifying the time the transfer prices are determined, the tax authorities should be enabled to assess the time interval at which the taxpayer generally reviews the arm's length nature of its actual business transactions.

As the "outcome-testing" approach is still common practice in many countries, taxpayers must assess the arm's length nature of transfer prices from an ex-ante and ex-post perspective, taking into account the respective foreign transfer pricing regulations.

Serious effort (sections 36 and 44)

As explained in paragraph 3.4.12.3 VWG-Verf., all documents provided have to show the serious effort of the taxpayer in terms of section 90 para 3 AO to arrange its business relations in accordance with the arm's length principle (section 2 para 1 GAufzV). New is the reference that such a "serious effort" is to be made plausible on the basis objective measures.

Information on functions, assets and risks (section 41)

The 2020 Administrative Principles provide for an exemplary overview in table form of the information to be submitted with regard to functions, assets and risks for certain "activities" which may be of "particular importance". The aspects of risk control and risk management contained in the OECD Transfer Pricing Guidelines 2017 are also listed as functions.

Comprehensibility (section 42)

Similar to paragraph 1.51 of the OECD Transfer Pricing Guidelines 2017, the documents presented must allow a knowledgeable person to reach within reasonable time a basic understanding of the value-adding activities within the group of companies, the business model and the functional and risk profile of the transaction partners. In comparison to the VWG-Verf., this means that there is no longer only a general reference to the arm's length principle but also to specific elements of the documentation of the underlying factual circumstances.

Selection of the transfer pricing method (section 46)

The tax authorities are entitled to choose the "correct" transfer pricing method, i.e. the transfer pricing method they based on their own merits consider most suitable. A correction of the results should only be made - analogous to the previous regulations of the VWG-Verf. 3.4.20 - if the results according to the method chosen by the tax authorities are considered "more probable" than the results of the taxpayer's method; a definition of the wording "more probable" is missing as it was in the VWG-Verf.

At the same time, however, the taxpayer must provide the information required for this process. It is noted that this change in the transfer pricing method may apply in cases of "uncertainties about the comparability of data".

The previous regulations of the VWG-Verf. did not provide for this right by the tax authorities to select the "correct" transfer pricing method, but only opened up the possibility for the tax authorities to carry out calculations using other transfer pricing methods for the purpose of checking the results' plausibility. The choice of the "correct" transfer pricing method also seems to be subject to discussion in view of the wording of paragraph 2.1 of the VWG-Verf., according to which "when assessing the documents submitted, it must be taken into account that in transfer pricing cases there is regularly not only one correct arm's length price relevant for taxation or only one correct result corresponding to the arm's length principle".

Assumptions and sensitivity analyses for the hypothetical arm's length test (section 47)

If the hypothetical arm's length test is applied, the assumptions and parameters on which the valuation is based and their arm's length nature must be disclosed. In addition, sensitivity analyses of the valuation result determined should be performed using alternative model assumptions and parameters.

Consideration of actual circumstances (section 48)

Analogous to the requirements of the OECD Transfer Pricing Guidelines 2017 (e.g. para 1.46), the tax authorities now also explicitly require that the records/documentation not only refer to the concluded (contractual) agreement, but also to the actual circumstances and thus actual conduct of the parties involved. Even though the legislative efforts to implement the DEMPE approach of the OECD Transfer Pricing Guidelines 2017 and the associated economic approach into German law have failed so far, the German tax authorities consider the new interpretation of the arm's length principle to be covered already by the existing legal framework, i.e. the contractual agreements are not the only factor in the delineation of risk.

Transfer pricing guidelines (section 52)

The taxpayer has to present any and all internal group transfer pricing guidelines as part of the transfer pricing documentation and, in individual cases, justify deviations from the transfer pricing guidelines and explain the appropriateness of such deviations.

Thus the 2020 Administrative Principles place more extensive requirements on the taxpayer's records/documentation to be submitted as compared to the relevant provisions of the GAufzV, since under Section 2 para 3 sentence 5 of the GAufzV group transfer pricing guidelines that are in accordance with the arm's length principle "may" be part of the records (i.e. the taxpayer has the option to provide the guidelines).

Master file (sections 54 and following)

The content of a master file mentioned in section 5 para 1 sentence 1 GAufzV and the appendix to section 5 GAufzV represent a conclusive list, so that consistency with the OECD requirements appears to be intended. Undefined legal terms are to be interpreted on the basis of the respective contents of the OECD Transfer Pricing Guidelines 2017.

If the obligation to keep records with regard to the master file is violated, means of coercion ("*Zwangsmittel",* section 328 AO) or a delay payments ("*Verzögerungsgeld*", section 146 para 2b AO) can be applied.

Estimation of tax bases and penal surcharges (section 162 AO) (section 67 through 91)

General information (sections 67 through 74)

The 2020 Administrative Principles state that the tax authorities' right to estimate the taxpayer's income based on section 162 para 1 and 2 AO is not limited only to cases in which non-usable records/documents are provided. The underlying reasoning provided by the 2020 Administrative Principles is that also with usable records/documents an estimation may be permissible, since usable records/documents represent only the starting point for the tax authorities' audit process.

One condition for the correction of income in terms of section 162 para 1 and 2 AO for usable records/documents is that there is a "high probability" that the transfer prices applied by the taxpayer do not lead to arm's length results and that the transfer prices determined by the tax authorities are "at least more probable".

The 2020 Administrative Principles do not state how the degree of probability should be determined and when a "high" probability can be assumed.

Estimates according to section 162 para 1 and 2 AO (sections 75 through 79)

In the 2020 Administration Principles it is, however, made clear that in transfer pricing cases no "exaggerated requirements" are to be placed by the tax authorities on the evidence to be provided when estimating an arm's length result according to section 162 para 2 AO.

In addition, the estimation methods should also be permissible which are otherwise not appropriate in the context of transfer pricing analyses (such as among others comparison of reference rates and industry averages).

In contrast to this, the fiscal court of Munich decided in its ruling of November 26, 2019 (pending before the Federal Fiscal Court) that the use of external data, e.g. from internet and press articles, by the tax authorities is not sufficient for a proper transfer pricing analysis.[4]

Estimates according to section 162 para 3 AO and surcharge according to section 162 para 4 AO (sections 80 through 90)

Section 162 para 3 AO remains unchanged also in cases of the non-usability or non-provision of records/documents as well as the late documentation of extraordinary business transactions in line with section 90 para 3 sentence 8 AO in connection with section 3 GAufzV, which provides for the tax authorities' right to estimate the tax base.

The 2020 Administrative Principles contain a non-exhaustive list of examples as to when the records/documents are considered to be non-usable. These include in particular:

- The absence of documentation of relevant facts and circumstances or an inappropriate presentation of facts (also with regard to a deviation from contractual situations).
- The absence of documentation analyzing the appropriateness of the transfer prices or the use of third-party data that does not fit the functional and risk profile of the tested party.
- No adequate justification is provided for the comparability of the third-party data.

[4] FG Munich v. 26.11.2019 - 6 K 1918/16 , DStRE 2020, 477, no. 74; see also Sommer/Kundt/Cockx, ISR 2020.

- The application of the selected transfer pricing method is not demonstrated.

If records of extraordinary business transactions are prepared after the actual due date in accordance with section 90 para3 sentence 8 AO and section 3 GAufzV, these should at least have an indicative evidential value in the context of the estimate.

If surcharges are determined in the course of the estimate according to section 162 para 4 AO, then these can refer to different breaches of duties (i.e. non-submission, non-usability, late submission of usable records/documentation) relating to different requests from the tax authorities.

It is also further stated that the surcharge for late submitted but usable records/documents in terms of section 162 para 4 sentence 3 AO (providing for at least 100 EUR for each full day of exceeding the submission deadline up to a maximum of 1,000,000 EUR) can turn out to be higher than the surcharge for the non-submission or the submission of unusable records/documentation in terms of section 162 para 4 sentence 1 and 2 AO.

Withdrawal of previous administrative regulations

The 2020 Administrative Principles state that the VWG-Verf. are still to be applied as far as questions regarding the application of sections 90 and 162 AO are not concerned. In this respect, the explanations in the VWG-Verf. on, among other things, company characterization and transfer pricing (3.4.10.2), transfer pricing methods (3.4.10. 3), benchmarking ranges and the narrowing thereof (3.4.12.5), comparability (3.4.12.7), retrospective price determination or adjustments (3.4.12.8) and multi-year analyses (3.4.12.9) are still effective.

Conclusion and Outlook

In addition to some clarifications, the 2020 Administrative Principles contain in part significant intensifications of the position of the tax authorities.

For example, it is made apparent that the tax authorities see the economic approach as contained in the OECD Transfer Pricing Guidelines 2017, i.e. the focus on the actual business conduct, as already being covered by the existing legal framework in Germany, although legislative efforts within the framework of the ATAD Implementation Act to implement this new interpretation of the arm's length principle into German law have failed so far.

Even if it seems, therefore, questionable whether the position of the tax authorities as codified in the 2020 Administrative Principles is covered in terms of its content by section 90 AO and section 162 AO, as well the existing ordinance (in particular GAufzV), additional discussions between taxpayers and tax authorities are to be expected without doubt as a result of the now published 2020 Administrative Principles.

In this respect, it is strongly recommended that taxpayers analyze the content of the 2020 Administrative Principles in order to be prepared for future discussions in the context of tax audits.

We will of course inform you about the 2020 Administrative Principles in the February issue of our newsletter Transfer Pricing Perspectives for the regions Germany, Austria and Switzerland.